No. 148

In the Supreme Court of the United States

OCTOBER TERM, 1959

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ROBLEY H. EVANS AND JULIA M. EVANS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 24-33) are not officially reported. The opinion of the Court of Appeals (R. 101–119) is reported at 264 F. 2d 502.

JURISDICTION

The judgment of the Court of Appeals was entered on January 26, 1959. (R. 120.) On April 23, 1959, by order of Mr. Justice Douglas, the time within which to petition for a writ of certiorari was extended to and including June 25, 1959. (R. 120–121.) The petition was filed on June 25, 1959, and the writ was granted on October 12, 1959, 361 U.S. 812. (R. 121.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

The taxpayer is in the business of leasing automobiles to a corporation which in turn leases and rents automobiles to the public. Because the corporation's customers demand late-model automobiles, taxpayer customarily sells his automobiles before the end of their physical life for a substantial price. The question, relating to the "reasonable" allowance for depreciation authorized by Section 23(l) of the Internal Revenue Code of 1939, is whether the leased automobiles are depreciable (as the Commissioner contends) on the basis of their estimated useful life in the taxpayer's business, using a depreciation base consisting of cost less the substantial resale value of the automobiles at the end of their useful life in taxpayer's business, rather than (as the court below held) on the basis of the longer physical life of the automobiles, with cost less salvage value at the end of their physical life as the depreciation base.*

STATUTE AND REGULATIONS INVOLVED

Sections 23(l) and 3791 (a) and (b) of the Internal Revenue Code of 1939, and Sections 29.23(l)–1, 29.23(l)–2, 29.23(l)–4 and 29.23(l)–5 of Treasury Regulations 111 are set forth in Appendix A, *infra*, pp. 36–39.

STATEMENT

This case concerns the allowance for depreciation of certain automobiles for the taxable years 1950 and 1951. The facts, which were stipulated in part (R. 20–24), were found by the Tax Court as follows:

* The question is presented in concrete, and perhaps more understandable, form by the illustrative example stated in footnote 6, page 14, *infra*.

The taxpayers, Robley H. Evans and Julia M. Evans, are husband and wife residing in the State of Washington. During the taxable years 1950 and 1951, Robley H. Evans (hereafter called the taxpayer) was engaged in the business of leasing automobiles in the vicinity of Seattle. During 1950 and 1951, he leased all of his automobiles to Evans U-Drive, Inc., a corporation,[1] at the rate of $45 per month per automobile. The leasing agreement between taxpayer and U-Drive provided that taxpayer would furnish and lease to U-Drive a sufficient number of automobiles to operate and conduct efficiently an automobile rental business. Taxpayer retained title to the automobiles and had the right to sell and dispose of any of the automobiles at any time. U-Drive agreed to pay all expenses of maintenance and repair of the automobiles and also to keep them insured against liability for personal injury or property damage. U-Drive also assumed the risk of loss or damage. U-Drive engaged in two types of activity during the taxable years. It leased about thirty to forty percent of its automobiles to customers for long periods of time, eighteen to thirty-six months, and it rented the remainder of its automobiles to the general public on a short-term basis, for a few hours, a few days or a few weeks. (R. 26–27.)

Taxpayer normally kept a supply of automobiles on hand which he purchased new from local automobile dealers, usually at the factory price. He endeavored to maintain a modern fleet of rental automobiles as

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[1] U-Drive was organized in 1949. All of its outstanding stock was held by taxpayer's son until near the end of 1951 at which time taxpayer acquired a portion of the stock. Taxpayer was the manager of U-Drive. (R. 26.)

this was necessary to meet the demands of U-Drive's leasing and rental business. Periodically, he owned more automobiles than were necessary for the efficient operation of U-Drive's short-term rental business. When this situation occurred, he would examine the cars in use and would sell those that were not needed. The oldest and least desirable automobiles were sold first. When sold, they usually had been driven an average of 15,000 to 20,000 miles and were generally in good mechanical condition. Many automobiles were sold at the end of the tourist season, after Labor Day. At the termination of U-Drive's extended-period leases, the automobiles would be returned to taxpayer who would sell them. When sold, they might have been driven up to 50,000 miles. They were usually in good mechanical condition and state of repair at the time of sale. (R. 27-28.)

The surplus automobiles sold by taxpayer could have been used longer than they were; however, customers of U-Drive demanded late-model automobiles that were currently in style. Older automobiles did not have much value as rental vehicles. During the taxable years, taxpayer sold the automobiles used by U-Drive in the short-term rental phase of its business after they had been used about fifteen months. And he usually sold the automobiles which had been leased for extended periods as soon as the lease was terminated. If a new lease was executed, a new car was usually provided for the lessee. Taxpayer sold most of his automobiles to used car dealers, jobbers or brokers. As a general rule, the cars were sold at current wholesale prices. Taxpayer did not adver-

tise the sales nor did he maintain a showroom or any other retail facilities for sale of his surplus automobiles. (R. 28.)

Taxpayer's returns for 1950 and 1951 disclosed that he sold 140 and 147 automobiles, respectively, in those years. The average cost, sales price, depreciation claimed, and gain per automobile were approximately as follows:

Year	Cost	Sales price	Depreciation claimed	Gain
1950	$1,650	$1,380	$515	$245
1951	1,495	1,395	450	350

Most of the automobiles sold had been held by taxpayer less than fifteen months. On his returns, taxpayer claimed depreciation on the automobiles he leased to U-Drive in amounts computed on the basis that the automobiles had an estimated useful life of four years, with no salvage value at the end of the four-year period. (R. 28–29.)

The Commissioner recomputed the allowable depreciation on the theory that, for purposes of depreciation, useful life means the useful life of an asset in the particular taxpayer's business, which may, as in this case, be shorter than physical life; and that salvage value is not limited to the scrap or junk value of the asset, but may be (as here) the substantial resale value remaining in the asset at the time it proves no longer useful in the particular taxpayers' business. On this basis, the Commissioner estimated the useful life of taxpayer's automobiles to be seventeen months and the salvage value $1,325 at the end of that period (or the amount of unde-

preciated cost at January 1, 1950, for automobiles in use at that date, if less than $1,325). (R. 29, 103–104.)

The Tax Court accepted the Commissioner's view of useful life and salvage value, but made separate findings as between the short-term and extended-term rental cars. (R. 29–30.) The Tax Court found that the automobiles leased to U-Drive during the taxable years for use under extended-term leases had a useful life of three years and a salvage value of $600. However, if the undepreciated cost of such automobiles in service at January 1, 1950, is less than $600, then that amount is to be taken as the salvage value of those automobiles. It also found that the automobiles leased to U-Drive during the taxable years for short-term rental use had a useful life of fifteen months and a salvage value of $1,375. However, if the undepreciated cost of such automobiles in service at January 1, 1950, is less than $1,375, then that amount is to be taken as the salvage value. (R. 29–30.)

Upon taxpayer's appeal, the Court of Appeals reversed and remanded, holding that the Tax Court had erred when it measured useful life of the automobiles by the period during which they were held in the business of taxpayer, instead of the physical or economic life of these assets, and that the application by the Tax Court of an erroneous concept of "useful life" necessarily required a redetermination by the Tax Court of "salvage value." The Court of Appeals pointed out that the Tax Court had determined salvage value to be the estimated proceeds which

would be realized from the automobiles when they were no longer useful in taxpayer's business rather than the estimated proceeds which would be realized upon the sale or other disposition of these assets at the end of their physical or economic life. In remanding, the Court of Appeals directed that the period over which useful life—meaning the physical or economic life—extends and the salvage value at the end of such period be determined by the Tax Court.[2] (R. 115.)

SUMMARY OF ARGUMENT

Taxpayer, who is engaged in the car rental business, retains cars for a relatively short period (in the case of most vehicles, approximately fifteen months) and then disposes of them by sale, receiving, on the average, a price which does not fall far short of original cost. Since this taxpayer is not deemed to be primarily engaged in the business of selling automobiles, the vehicles, for tax purposes, are depreciable capital assets rather than ordinary stock in trade. This case concerns the method of depreciation which may properly be employed in relation to these assets.

The allowance for depreciation is designed to return to a taxpayer, tax-free, the cost of his capital asset over the period that it is useful to the taxpayer in his business. The amount of the allowance, as Mr. Justice Brandeis stated for the Court in *United States* v. *Ludey*, 274 U.S. 295, 300–301, "is the sum which should

[2] In this connection the court below noted (R. 115), "We do not agree with the petitioner's [taxpayer's] contention that the value remaining in such assets at the end of their physical or economic life necessarily means scrap or junk-value."

be set aside for the taxable year, in order that, at the end of the useful life of the [asset] in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost."

Consistently with this classic statement of the rule, the Commissioner has taken the position that taxpayer should depreciate its automobiles over the period during which (according to best estimate) they will be used in taxpayer's business. This means that the taxpayer should (1) ascertain the probable salvage value as of the conclusion of the anticipated holding period; (2) subtract that salvage value from original cost; and (3) apportion the resulting figure over the period in question according to a reasonably consistent plan.

Taxpayer, on the contrary, urges that he may depreciate the cars *as if* he were going to retain them for their entire economic life. Proceeding on this contrary-to-fact assumption, taxpayer assumes further that salvage value need play no role (or at most a negligible one) in the computation.

The view that useful life, for purposes of computing depreciation, means useful life in the taxpayer's business (and not the period during which the asset may prove useful to someone) is supported by decisions of this and other courts (including the decisions of the Third and Fifth Circuits in the closely related *Hertz* and *Massey* cases, now pending before this Court, Nos. 283 and 141, respectively). It finds consistent expression, over a long period of years, in the regulations and other authoritative pronouncements of the

Treasury. Congress, moreover, used the phrase "useful life" in the same sense when it employed it, for the first time, as a statutory term in the 1954 Code—a factor which is significant (although the tax years here involved are 1950 and 1951) because Congress was making no change in the settled concept of depreciation.

By proceeding on the false premise that he will use the cars for the duration of their economic life (whereas, in fact, they are used for relatively short periods), taxpayer finds it possible to ignore the circumstance that he receives very substantial sums (representing, in 1950, more than 80 percent and, in 1951, more than 90 percent of original cost) upon their resale. Having effectively shunted salvage value from the picture and having thus eliminated the natural ceiling which it imposes upon claims for depreciation, taxpayer takes depreciation in amounts substantially greater than would otherwise be available. Since depreciation is a deduction from ordinary income, income taxes are thereby reduced. It is true, to be sure, that the inflation of depreciation reduces, *pro tanto,* the cost basis of the asset, and to that extent, increases the liability for capital gains. Capital gains are taxed, however, at more favorable rates.

The Commissioner's position not only accords with the authorities—the decisions and regulations; it is also in accord with reasonable practice and with common sense. Significantly, an important segment of the automobile leasing industry (the companies represented by the American Automotive Leasing Association) has expressly acknowledged that depreciation

on automobiles should be taken by car rental firms on the basis of the period during which it is estimated that such assets will be used in the leasing business. The Association has disavowed practices which would "permit the leasing industry to be used as a device or a gimmick to convert ordinary income into capital gains."

ARGUMENT

USEFUL LIFE, FOR PURPOSES OF DEPRECIATION, IS THE PERIOD DURING WHICH AN ASSET IS USEFUL TO THE TAXPAYER IN HIS BUSINESS AND SALVAGE VALUE IS THE AMOUNT WHICH MAY REASONABLY BE EXPECTED TO BE RECEIVED FROM THE SALE OF THE PROPERTY AFTER IT HAS LOST ITS UTILITY IN SUCH BUSINESS

A. INTRODUCTION

Taxpayer is in the car rental business. Because of the nature of his business operation, he regularly disposes of cars employed in the business at a time when the vehicles are still in good and usable condition. Under Section 117 of the Internal Revenue Code of 1939 (26 U.S.C., 1952 ed., Section 117), capital gain rates are available with respect to certain property used in the taxpayer's business, but not available with respect to "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[3] The Commissioner does not contend that the taxpayer here holds his automobiles primarily for sale. Concededly, if tax-

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[3] Under Section 117(j) of the 1939 Code and the comparable successor provision of the 1954 Code (26 U.S.C., 1958 ed., Sec. 1231), gain realized on the sale of depreciable assets used in a trade or business (but not held primarily for sale) and held for more than six months is taxable as capital gain.

payer, after holding a car for a period of time and employing it in the rental business, sells that car at a gain, the gain is entitled to treatment as a capital gain. The question in this case bears upon the proper computation or determination of capital gain. More particularly, it involves the proper method of taking depreciation as a deduction from ordinary income—depreciation being directly relevant to capital gain determination since every dollar taken by way of depreciation is subtracted from the cost basis of the property. For example, if depreciation is taken in inflated amounts, capital gain is artifically enhanced (because the cost basis of the property is artificially lessened). By the same token, in such a case ordinary income is artificially (and correspondingly) lowered, since depreciation is chargeable against business income. The Government contends in this case, as will appear below, that depreciation is being taken by the taxpayer on an unrealistic basis; that this approach artificially reduces ordinary income and enhances capital gain; and that it produces the end consequence that income which should be taxed at ordinary rates is ultimately taxed at the more favorable rates applicable to capital gains.[4]

Section 23(l) of the Internal Revenue Code of 1939 (Appendix A, *infra*, p. 36) and Section 167(a) of the Internal Revenue Code of 1954 (Appendix B, *infra*, p. 40) provide for a depreciation deduction of—

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[4] The same general problem is also presented in *Massey Motors, Inc.* v. *United States*, No. 141, and *Hertz Corp.* v. *United States*, No. 283, which are being argued together with this case.

A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

Generally, several factors must be taken into account in the determination of allowable depreciation—(1) whether the property is depreciable in the first instance, (2) the cost or other basis to be recouped through the depreciation allowance, (3) the period of time over which this recoupment is to be made (the "useful life" of the property), and (4) the estimated value of the property which can be expected to be recovered on the sale or other disposition of the property at the end of its useful life (the "salvage value" of the property). No problem is presented in this case (or in the *Hertz* and *Massey* cases) as to the cost or other basis to be recovered through the deduction for depreciation and we concede that the property is depreciable. We are concerned exclusively with the "useful life" of the property and with its salvage value.

Briefly stated, the taxpayer's position, which was upheld by the Court of Appeals, is that the "useful life" of the property is ascertained by discovering the period during which the property can be expected to be economically useful in *any* business (approximating its expected physical life) and "salvage value" is to be limited to scrap or junk value. The high salvage (or resale) value to taxpayer—what

taxpayer will predictably realize upon resale following a relatively short holding period—is thus shunted from the picture so that taxpayer may "assume" a depreciation which he knows, upon the basis of his practice, his plan and his experience, will not occur.

The Commissioner's position, on the other hand, is that "useful life" is that period during which the property involved can reasonably be expected to be useful *in the business of the particular taxpayer involved,* that is, useful for the purpose for which the particular taxpayer acquired the property. Salvage value, under our view, would be that amount which the particular taxpayer could reasonably expect to receive on the sale or disposition of the property at the point that it has lost its utility in his business. In many instances, of course, the period of general economic utility of an asset will coincide with the period during which the particular taxpayer can reasonably expect to use the asset. It is only in cases such as the one at bar, where because of the peculiar nature of the business the asset must be replaced while it is still generally usable, that the definition of "useful life" becomes important.[5]

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[5] Although the court below stated (R. 115) that it did not agree with taxpayer's contention that the value remaining in the automobiles at the end of their physical or economic life *necessarily* means scrap or junk value and left this question, as well as the physical or economic life of the assets, to be determined by the Tax Court on remand, it seems plain that the salvage value of the cars at the end of the period during which they are useful to taxpayer in his business far exceeds any value they may be found to possess at the end of their physical life.

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We shall urge that only by adopting the Commissioner's approach—an approach which has been accepted by the Courts of Appeals for the Third and Fifth Circuits in *Hertz Corp.* v. *United States*, 268 F. 2d 604, and *United States* v. *Massey Motors*, 264 F. 2d 552—can the depreciation deduction fulfill the purpose for which it is intended. The approach of the court below results, in our view, in a distortion of the basic concept and purpose of depreciation; and it thereby permits the depreciation deduction to serve as a ready and convenient device for converting ordinary income into capital gain.[6]

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[6] It may be useful to point out, purely in terms of practical monetary consequences, how the differences in legal theory may affect tax liability. The following illustration (in which we use hypothetical facts and figures for the sake of simplicity) is offered for this purpose:

Cost of car to taxpayer	$1,600
Sales price of car upon disposition by taxpayer at end of one year	1,500
Depreciation based upon four years' "useful life" and no salvage value (taxpayer's theory)	400
Depreciation based on one year's "useful life" in taxpayer's business and limited by salvage value of $1,500 (Commissioner's theory)	100

As shown above, taxpayer's theory, applied to the hypothetical case, results in $400 depreciation. (Depreciation, of course, is chargeable against ordinary income.) It also results in a capital gain of $300: Resale price of $1,500 less adjusted basis of $1,200 (original cost of $1,600 less $400 in depreciation) equals $300.

The Commissioner's theory, on the other hand, yields a depreciation figure of $100 and no capital gain or loss (since the resale price is $1,500 and the adjusted cost basis is also $1,500).

The practical difference between the two computations, then, is that the taxpayer's theory yields $300 more depreciation

B. THE STATUTORY PURPOSE UNDERLYING AN ALLOWANCE FOR DEPRECIATION AND THE CONSISTENT ADMINISTRATIVE PRACTICE SUPPORT THE CONCLUSION THAT THE "USEFUL LIFE" OF A DEPRECIABLE ASSET IS THAT PERIOD DURING WHICH THE ASSET CAN REASONABLY BE EXPECTED TO BE USED IN THE BUSINESS OF THE PARTICULAR TAXPAYER INVOLVED

1. The justification for a depreciation allowance is essentially simple—that an investment in a business asset subject to wear and tear should be deducted from taxable income over the course of that period during which the asset is productive in taxpayer's business, so that through such deductions (together with salvage value) he may recover, for tax purposes, his capital investment in the asset. This theory has been many times recognized by this Court as the underlying basis for the depreciation deduction. For example, in *United States* v. *Ludey,* 274 U.S. 295, 300–301, the Court, per Brandeis, J., said:

> The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory

(hence, $300 less in ordinary income and $300 more in capital gain) than the Commissioner's. Changing the figures will not alter the principle: to whatever extent depreciation is enhanced, the cost basis of the capital asset is correspondingly reduced.

underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. * * *

Again, in *Detroit Edison Co. v. Commissioner,* 319 U.S. 98, 101, this Court stated:

> It will be seen that the rule applicable to most business property of a cost basis properly adjusted leaves many problems of depreciation accounting to be answered by sound and fair tax administration. The end and purpose of it all is to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets. For this purpose it is sound accounting practice annually to accrue as to each classification of depreciable property an amount which at the time it is retired will with its salvage value replace the original investment therein. * * *

See also *Gambrinus Brewery Co.* v. *Anderson,* 282 U.S. 638, 643; *Virginian Hotel Co.* v. *Helvering,* 319 U.S. 523, 528; *Cohn* v. *United States,* 259 F. 2d 371, 377 (C.A. 6th); *Becker* v. *Anheuser-Busch,* 120 F. 2d 403, 412 (C.A. 8th), certiorari denied, 314 U.S. 625; *Burlington Gazette Co.* v. *Commissioner,* 75 F. 2d 577, 578 (C.A. 8th); *Cameron* v. *Commissioner,* 56 F. 2d 1021, 1023 (C.A. 3d). See also Treasury Regulations on Income Taxes (1954 Code, Section 1.167(b)-1) (Appendix B, *infra,* p. 42).

The only way in which the depreciation allowance can be made to effectuate this declared purpose is by adopting the view urged herein—that depreciation must be computed by using a rate determined by the expected useful life of the asset *in the taxpayer's*

business and by taking into account an estimate of salvage value at the end of that period. One cannot properly adopt a technique whereby depreciation for the period that the property is held will regularly exceed the difference between the cost of the depreciable asset and its reasonably anticipated salvage value at the conclusion of the anticipated holding period. If salvage value should exceed reasonable expectation—if, for example, the value of used cars should suddenly increase as a result of wartime conditions—realization of capital gain would not show that the method of computing depreciation was impermissible. Our point is that a correct plan or technique of depreciation will not consistently produce capital gains in an ordinary or stable market.

In the instant case, one finds that the taxpayer claimed depreciation in 1950 (per average car) of $515. In 1951, the figure was $450. In contrast, the sales price of the average car at the time it ceased to be useful in the business was $270 less than original cost in 1950 and $100 less than original cost in 1951.

In *Massey*, the facts are even more striking. There, it appears, the cars were sold by the taxpayer, at the end of the holding period, for amounts in excess of original cost. Taxpayer nonetheless claimed substantial depreciation, urging that "useful life" means physical life (regardless of the period of time that taxpayer intends to hold the property) and that no salvage value would remain thereafter. Rejecting this approach, the Court of Appeals concluded (264 F. 2d at 558) "that as to a taxpayer so placed

that his business experience has taught him that automobiles * * * with use in the business averaging less than one third of their total usable life can then be sold at substantially the original cost to him, such automobiles are depreciable by him on the basis of his expected use of the cars in his business and not on the basis of the length of time the car is expected to be usable as a passenger automobile."

The *Hertz* case is still more extreme. There, taxpayer claimed depreciation under the declining balance method at double the straight line rate. Although such accelerated depreciation is available only with respect to assets having a useful life of three years or more, the taxpayer sought to avail itself of this method by contending that its automobiles had a useful business life of four years notwithstanding the fact that it used them only for a period slightly in excess of two years. As in *Massey,* the Court of Appeals held that "the accepted meaning of the term useful life has always been the period of usefulness of the asset to the taxpayer in his business" (268 F. 2d at 609). The court also rejected the notion (*ibid.*) that one may adopt a technique of depreciation calculated "to depreciate the asset below a reasonable salvage value."

In order to ignore salvage value, taxpayer must base his depreciation not on the experience of his business, but on an artificial assumption, contrary to fact, that he uses cars for their full physical life, allegedly four years. The statute prescribes a "reasonable allowance" for depreciation *for the particular taxpayer involved* and it is his invest-

ment, not that of some possible successor in title (which might, and probably would, be different), that is to be recovered through the depreciation deduction. This can only be accomplished by measuring the period during which depreciation is to be allowed by the time during which the asset is expected to be useful to the particular taxpayer and estimating a salvage value at the end of that period. This is not to contend for a hindsight determination of the actual period of usefulness to the taxpayer or of salvage value. Rather, the estimates of useful life and salvage value should be made at the time of acquisition of the asset.[7] These estimates should be based on the past experience of the taxpayer and a reasonable prediction as to whether past experience is likely to be repeated for the asset, taking into account any changed circumstances that might be relevant.

2. Almost from the inception of modern income tax law, the Treasury Regulations have expressed the same concept of depreciation which the Commissioner urges in the instant case—a concept which was accepted by this Court, in 1927, in its opinion in *United States* v. *Ludey, supra.* Indeed, the formulation in the *Ludey* opinion, quoted above (pp. 15–16), is almost a paraphrase of Article 161 of Treasury Regulations 65, promulgated under the Revenue Act of 1924, which read in relevant part as follows:

> * * * The proper allowance for such depreciation of any property used in the trade or

[7] Changes in circumstances could give rise to adjustments of these estimates.

> business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the basis of the property * * *."

The statement was consistently repeated in later regulations.[9] And it appeared again when the first regulations were promulgated under the Internal Revenue Code of 1939.[10] During the period that regulations used language referring to the useful life of the property in the business, Congress, time and again, reenacted the provision for depreciation deduction without making any change significant for present purposes.[11]

[8] For other similar statements appearing in the early regulations, see Article 161 of Treasury Regulations 45 (1919 and 1920 eds.), 62 and 69 promulgated under the Revenue Acts of 1918, 1921 and 1926. A preliminary draft of the regulations under the 1918 Act, also containing similar language, was published as House Document No. 1826, 65th Cong., 3d Sess.

[9] See Article 201 of Treasury Regulations 74 and 77, promulgated under the Revenue Acts of 1928 and 1932 and Article 23 (l)-1 of Treasury Regulations 86, 94 and 101, promulgated under the Revenue Acts of 1934, 1936 and 1938.

[10] Treasury Regulations 103, Section 19.23(l)-1 (Appendix B, *infra*, p. 45).

[11] See Sections 214(a)(8) and 234(a)(7) of the Revenue Acts of 1918, c. 18, 40 Stat. 1057; of 1921, c. 136, 42 Stat. 227; of 1924, c. 234, 43 Stat. 253; and of 1926, c. 27, 44 Stat. 9; Section 23(k) of the Revenue Acts of 1928, c. 852, 45 Stat. 791, and of 1932, c. 209, 47 Stat. 169; Section 23(l) of the Revenue Act of 1934, c. 277, 48 Stat. 680; of 1936, c. 690, 49 Stat. 1648; and of 1938, c. 289, 52 Stat. 447; Section 23(l) of the Internal Revenue Code of 1939.

Taxpayer has relied in this litigation upon a change in the regulations which took place shortly after the enactment of the Revenue Act of 1942. Treasury Regulations 111 (October, 1943), Section 29.23(l)-1 [12] (Appendix A, *infra*, p. 37), state:

> A reasonable allowance for the exhaustion, wear and tear, and obsolence of property used in the trade or business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, may be deducted from gross income. * * * The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the *depreciable property*, equal the cost or other basis of the property determined in accordance with section 113. * * * [Emphasis added.]

The explanation of the change is cogently stated in the Fifth Circuit's opinion in the *Massey* case. Referring to the language quoted immediately above, that court observed (264 F. 2d at 557):

> It will be apparent that in the last sentence the words "property in the business" have been eliminated and the words "depreciable property" substituted. A cursory look at the legislative history back of this amendment clearly demonstrates that there was no purpose to express a change in what was meant by useful

[12] See, also, the amendment of Treasury Regulations 103, Section 19.23(l)-1 (T.D. 5196, 1942-2 Cum. Bull. 96, 100, December 1942).

life. This change was necessitated by an amendment in 1942 to the 1939 Code, which *added* as property entitled to depreciation "property held for the production of income." Thus the regulation which had theretofore dealt only with property used in the trade or business was inadequate, and it had to be amended by the inclusion of the italicized words above. The last sentence could not, of course, thereafter adequately cover both classes of property by referring to "property in the business" because this would not include the new class "property held for the production of income." The language "depreciable property" would, of course, cover both, and it was substituted for "property in the business." [13]

Thus, we think it clear that whatever was understood by the Treasury Department prior to 1942 by useful life remained unchanged by the amendments here discussed.[14]

[13] The statutory change noted in the quotation was made by the enactment of Section 121(c) of the Revenue Act of 1942, c. 619, 56 Stat. 798, which amended Section 23(l) of the 1939 Code.

[14] The court below construed the words "in the business" in the prior regulations to have "simply defined the type of assets which were subject to the depreciation allowance." (R. 109.) Section 19-23(l)-2 of Treasury Regulations 103 (the first Regulations promulgated under the 1939 Code), however, specifically defined the type of assets which were subject to the depreciation allowance. In view of the fact that a specific detailed definition of depreciable property was contained in Section 19-23(l)-2, the use of the words "in the business" in Section 19-23(l)-1 undoubtedly was intended to have a function other than that of mere definition. And this function, we submit, was to limit the concept of "useful life" to that time dur-

The court below was of the view (see R. 111–113) that a guide to taxpayers issued by the Internal Revenue Service—a publication known as Bulletin "F" (Revised January 1942) dealing with depreciation and setting out average rates by which to measure the useful life of various types of property—indicated that the Commissioner did not "consider that the useful life of an asset was to be measured by the estimated holding period of such asset by the taxpayer" (R. 113). The Fifth and Third Circuits drew the contrary inference in the *Massey* and *Hertz* cases. 264 F. 2d at 557–558; 268 F. 2d at 608.

The opinion in the instant case refers to language in the Bulletin which stated that assets used in the production of income are gradually worn out, exhausted or consumed over a period of years and that the period over which depreciation extends is the normal useful life. But there is no reason to suppose that this passage contemplated anything other than the normal situation in which the asset is worthless for business purposes after the period of use by the taxpayer. Indeed, this is made abundantly clear by other statements appearing in Bulletin "F". Thus, on the title page of Bulletin "F", the following appears:

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ing which the property was useful "in the business" of the taxpayer.

For a comprehensive article discussing the general problem here involved and supporting our position that the regulations have always defined the useful life of an asset in terms of its expected usefulness in the taxpayer's business, see Kirby, *Accelerated Depreciation and the Treasury Regulations*, 54 Northwestern Law Review 434 (September–October 1959).

Taxpayers and officers of the Bureau are cautioned against reaching conclusions in any case solely on information contained herein and should base their judgment on the application of all pertinent provisions of the law, regulations, and other Treasury Decisions *to all the facts in any particular case.* The *estimated useful lives* and rates of depreciation indicated in this bulletin *are based on averages and are not prescribed for use in any particular case.* They are set forth solely as a guide or starting point from which *correct rates may be determined in the light of the experience of the property under consideration and all other pertinent evidence.* [Emphasis added.]

Again, on page 2, Bulletin "F" reads:

The proper allowance for exhaustion, wear and tear, including obsolescence, of property used in trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of *the useful life of the property in the business,* equal the cost or other basis of the property. In no instance may the total amount allowed be in excess of the amount represented by the difference between the cost or other allowable basis and the salvage value which reasonably may be expected to remain at the end of the useful life of the property in the trade or business. [Emphasis added.]

And it is further stated (p. 7):

> Salvage value is the amount realizable from the sale or other disposition of items recovered when property has become no longer *useful in the taxpayer's business* and is demolished, dismantled, or retired from service. When reduced by the cost of demolishing, dismantling, and removal, it is referred to as net salvage. In principle, the estimated net salvage should serve to reduce depreciation, either through a reduction in the basis on which depreciation is computed or a reduction in the rate. * * * [Emphasis added.]

Although this case involves the tax years 1950 and 1951, the 1954 Code and its legislative history are significant to the extent that they reveal Congress' understanding of the depreciation concept and of the prior prevailing practice.

In the 1954 Code, Congress, for the first time, used the term "useful life" in the statutory provisions relating to depreciation. Section 167(c), Appendix B, *infra*, p. 41. The accompanying House Report (H. Rep. No. 1337, 83d Cong., 2d Sess., p. 22) stated:

> Depreciation allowances are the method by which the capital invested in an asset is recovered tax-free over the years it is used in a business. The annual deduction is computed by spreading the cost of the property over its estimated useful life. * * *

This statement, of course, supports our view of the depreciation concept. What is more, Congress was

of the opinion that it was making no change in the prevailing concept. Thus the Report goes on to state (H. Rep. No. 1337, *supra*, p. 25) that "The changes made by your committee's bill merely affect the timing and not the ultimate amount of depreciation deductions with respect to a property."

It is notable that regulations under the 1954 Code defining salvage value (Treasury Regulations on Income Taxes (1954 Code), Section 1.167(a)-1(c), Appendix B, *infra*, pp. 43-44) paraphrase the definition of salvage value (quoted *supra*, p. 25) which had long appeared in Bulletin "F". The court below concedes that under the current regulations useful life is the period over which the asset may be expected to be useful in the taxpayer's business. Yet, inconsistently, that court views Bulletin "F" as manifesting a contradictory past practice.[15] We submit that,

[15] In order to support its conclusion as to the proper interpretation of the regulations and of Bulletin "F," the Court of Appeals also referred (R. 113) to decisions of the Board of Tax Appeals and the Tax Court as indicating that the general economic or physical life of an asset was determinative in establishing a depreciation rate. *West Virginia & Pennsylvania Coal & Coke Co.* v. *Commissioner*, 1 B.T.A. 790; *James* v. *Commissioner*, 2 B.T.A. 1071; *Kay* v. *Commissioner*, 10 B.T.A. 534; *Foster* v. *Commissioner*, decided August 4, 1943 (1943 P-H T.C. Memorandum Decisions, par. 43,373); *Maguire Estate* v. *Commissioner*, 17 B.T.A. 394; *Lewis* v. *Commissioner*, decided December 27, 1954 (1954 P-H T.C. Memorandum Decisions, par. 54,339); *Whitman-Douglas Co.* v. *Commissioner*, 8 B.T.A. 694; *Sanford Cotton Mills* v. *Commissioner*, 14 B.T.A. 1210; *Merkle Broom Co.* v. *Commissioner*, 3 B.T.A. 1084; *Kurtz* v. *Commissioner*, 8 B.T.A. 679. An examination of these cases shows that each was considered on its own facts and that no generalizations were

in the words of the Third Circuit (*Hertz* case, 268 F. 2d at 609), "the accepted meaning of the term useful life has always been the period of usefulness of the asset to the taxpayer in his business."

C. THE TAXPAYER'S METHOD OF COMPUTING DEPRECIATION IN THE ABSTRACT, WITHOUT REGARD TO THE USEFUL LIFE OF THE PROPERTY IN HIS BUSINESS, RESULTS IN A DISTORTION OF INCOME AND PROVIDES A CONVENIENT METHOD FOR CONVERTING INCOME OTHERWISE TAXABLE AS ORDINARY INCOME INTO CAPITAL GAIN

The primary purpose of any system of accounting is to reflect clearly the income of the business for the accounting period. This is true whether the system is designed to compute income for tax purposes or for general accounting purposes. No method of accounting should suffice for either purpose if it results in a distortion of the income for the accounting period.

As argued above, the basic purpose of the depreciation allowance is to permit the taxpayer to recover his capital investment in the property being depreciated, taking into account its estimated salvage value. Another way of viewing the depreciation allowance, consistent with that purpose, is to consider the entire capital investment in the depreciable asset as an expense or cost paid in advance. This cost should properly be allocated over the productive life of the

intended as to the question of "useful life." As the Third Circuit concluded in *Hertz* with respect to these cases (268 F. 2d at 608):

"the issue was not squarely presented nor was any theory of useful life formulated therein; rather, the questions posed in the cases were treated as factual in nature. Thus they are of little, if any, use to us as precedents."

property in the business by depreciation deductions. In that manner, the cost of the asset is spread over the period of use and the gross income produced by the asset is reduced by so much of the cost as was incurred in producing the income. This Court stated the point in *Gambrinus Brewery Co. v. Anderson*, 282 U.S. 638, 642–643, as follows:

> The cost of plant depreciation, *i.e.*, exhaustion, wear, tear and obsolescence, is a part of operating expenses necessary to carry on a manufacturing business. The gain or loss in any year cannot be rightly ascertained without taking into account the amount of such cost that is justly attributable to that period of time.

When the instant case is examined in this light, the distortion of income resulting from taxpayer's method of depreciation becomes apparent. Thus taxpayer, in a period of fifteen months, has claimed depreciation deductions totaling $515 on an automobile the cost of which is $1,650, leaving a depreciated cost basis of $1,135. At the end of such fifteen-month period, the automobile is sold for $1,380 for a net gain of $245.[16]

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[16] Putting it another way, as the District Court did in the *Hertz* case (165 F. Supp. 261, 269, fn. 6), the transaction may be analyzed as follows:

Cost	$1,650.00
Depreciation (fifteen months)	515.00
Basis at time of sale	1,135.00
Sale price	1,380.00
Long-term capital gain	245.00
Tax on gain (not more than 25 percent)	61.25

(R. 29, 103.) This is not a recovery of cost or investment but a means of creating profits taxable at capital gains rates.

To the extent that this increased depreciation lowers the basis for the automobile, the taxpayer, of course, has an increased gain on the disposition of the car. But this, we submit, cannot answer the objections to this distortion of income, since the gain on sale is taxable as capital gain and not ordinary income. The result, if taxpayer is correct, is that through the medium of the depreciation deduction ordinary income can easily be converted into capital gain. On the other hand, if, as the Commissioner contends, the depreciation deduction must be based upon a rate determined by the period during which the asset can reasonably be expected to be used in the taxpayer's business and a reasonable estimate of salvage value at the end of that period, there will be no conversion of ordinary income into capital gain. Ordinary and predictable salvage value, determined as of the time that sale of the asset is contemplated, will impose a realistic ceiling upon depreciation claims.[17]

Net gain after taxes	\$183.75
Recovery through depreciation	515.00
Recovery of remaining basis through sale	1,380.00
Total recovery	2,078.75
Gain to taxpayer over original cost	428.75

And see the illustration set out in note 6, p. 14, *supra*.

[17] That proposals were made to Congress that there should be no capital asset treatment from gains on sales of depreciable assets and that such proposals were not adopted by Congress is no answer to the proposition that the depreciation deduction was not intended to allow taxpayers to convert ordinary income into capital gain.

The opinion below refers (R. 114–115) to the expert testimony of two accountants who testified as witnesses for taxpayer in the proceedings before the Tax Court. The import of their testimony was that "useful life" invariably means physical or economic life and that "salvage value" means junk value. Commenting on similar expert testimony which had been offered in the *Hertz* case, the Third Circuit pointedly observed (268 F. 2d at 608–609) that the standard work on tax accounting, edited by four partners in the accounting firm of Lybrand, Ross Bros. & Montgomery, is directly to the contrary. *Montgomery's Federal Taxes* (37th ed. (1958)), c. 6, p. 4.

Common sense dictates the conclusion that salvage value ought not be treated as junk value when the taxpayer knows that he is going to obtain his salvage (resale price) at a time when the depreciable asset is in eminently good condition and still retains the major portion of its economic life.

Perhaps, the most telling indication that the approach urged by the Government accords with common sense and reasonable business practice is that an important segment of the automotive leasing industry has openly acknowledged its correctness.

A recent case decided by the Tax Court, *Hillard* v. *Commissioner*, 31 T.C. 961, determined that a certain car rental firm which leased and thereafter sold its vehicles held those vehicles with a primary purpose of selling them in the ordinary course of business—a conclusion which meant that any gain realized from the sale of the vehicles was taxable under Section

117(j) of the 1939 Code as ordinary income. Upon taxpayer's appeal of that case to the Court of Appeals for the Fifth Circuit (where the case is now *sub judice*), a brief *amicus curiae*, dated October 1959, was filed on behalf of the American Automotive Leasing Association.[18] The Association comprises "about 65 percent of the long-term leasing industry in motor vehicles in the country" (Association Br., p. 8).[19] In its brief, the Association argues at length that the Tax Court misunderstood the nature of the automobile leasing industry and drew an erroneous legal conclusion in holding that the car rental firm in question was also engaged in the business of selling automobiles (a point not in issue in the present litigation). Accordingly, the Association argued that when a car rental firm, employing correct accounting practices, realizes a gain from the sale of cars, it is entitled to capital gain treatment.

Significantly, however, the Association was at pains to point out that it would not suggest that a car rental firm is entitled to enhance capital gain by taking depreciation for any period other than the expected useful life of the car in the taxpayer's business. The following excerpts are from its brief:

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[18] A copy of the Association's brief will be filed with the Clerk of this Court and copies will be served on opposing counsel in this and the companion *Massey* and *Hertz* cases.

[19] Members of the Association lease cars for one year or more. They do not lease them a second time as used cars, but dispose of them by sale. Their aggregate investment in vehicles is approximately $286,000,000. Association Br., pp. 7-9.

With respect to the matter of depreciation, it should be emphasized, at the outset, that the American Automotive Leasing Association in no way suggests that the business of leasing automobiles can, through the depreciation allowance, properly be used as a nice device to convert ordinary income into capital gains, to be taxed at the more favorable capital gains rates. We do urge strongly, however, that the business of leasing vehicles, when properly conducted, is a separate business which is most helpful and useful to the commercial and industrial community; that the disposition of vehicles when they are no longer useful in the leasing business is necessarily a part of that leasing business,—"a natural conclusion of a vehicle rental business cycle" (*Philber Equipment Corporation* v. *Commissioner*, 237 F. (2d) 129, 132 (C.A. 3, 1956);—and that if any gain over the depreciated basis of the vehicles is realized on their disposition, after they have been properly depreciated in accordance with applicable law and regulations, such gain may appropriately be reported and taxed on a capital gain basis. * * * [p. 9]

* * * * *

As has been noted, the American Automotive Leasing Association does not suggest that the business of leasing vehicles may be used to convert ordinary income into capital gains. The Association is in complete accord with the Internal Revenue Regulations on depreciation promulgated under the Internal Revenue Code of 1954 (T.D. 6182, Cum. Bull. 1956-1, 98 et

seq.,) and, at the time these Regulations were being considered by the Treasury Department, the American Automotive Leasing Association submitted both written material and oral testimony in support of the Regulations as finally issued.*

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*Inasmuch as the Association was not organized until 1955, its position has been expressed only with respect to the Internal Revenue Code of 1954 and Regulations thereunder. And although the case at bar arises under the Internal Revenue Code of 1939, the basic principles are essentially the same, and since they are expressed more fully and completely in the Regulations under the 1954 Code, we shall refer to those Regulations herein. See *United States* v. *Massey Motors, Inc.*, 264 F. (2d) 552, (C.A. 5, 1959); *The Hertz Corporation* v. *United States*, 268 F. (2d) 604, (C.A. 3, 1959); cf. *Robley H. Evans* v. *Commissioner*, 264 F. (2d) 502, (C.A. 9, 1959). All three cases are pending in the Supreme Court of the United States on petitions for writs of certiorari. [p. 10]

*   *   *   *   *

It is apparent from the foregoing that the depreciation allowance,—which essentially is designed to return to the taxpayer, tax-free, the cost of his capital asset over the period during which it is useful to the taxpayer in his business (*United States* v. *Ludey*, 274 U.S. 295, 300–301),—is based on estimates made in advance. If a taxpayer were a perfect prophet, there would never be either a gain or a loss on disposition of an asset when it was no longer useful in business. But the regulations recognize that no one can be a perfect prophet in making the estimates, and, accordingly, they make specific provision for the treatment of the

gains realized or the losses sustained on disposition after a "reasonable allowance" for depreciation had been taken,—the gain being recognized as entitled to treatment as a capital gain. Section 1.167(a)(8), T.D. 6182, Cum. Bull. 1956-1, 103-104. [p. 11]

* * * * *

Under the law, as we have already outlined, when a leasing company puts a fleet of vehicles in service, it is entitled to depreciate those vehicles on the basis of cost less reasonably estimated salvage value at the end of the period of estimated useful life. This is the entitlement and this is the obligation, and it is immaterial whether the period of use is one year, or two years or three years. This process is to enable the company to recover, by way of its annual depreciation allowance, plus salvage, its cost or other basis in the property. For example, if vehicles costing $2,000.00 new are used for leasing for one year, and it is reasonably estimated that the salvage value at the end of the one year period will be 70 percent of cost, or $1,400.00, the company is entitled to depreciate the remaining 30 percent, or $600.00, during the one year of use. If, on the other hand, the vehicles are to be used in service for a period of two years, the salvage value must be reasonably estimated as of the end of that two year period, and on the assumption that it is 50 percent of cost, or $1,000.00, the company is entitled to depreciate the remaining 50 percent, or $1,000.00, over the two year period. It is immaterial whether the cars are held one or two or three years or until they are junk.

> In each case, the total recovery is the $2,000.00 capital outlay. The legal principles are exactly the same regardless of the holding period, and the total recovery to the company is the same. * * * [pp. 25–26]

The Association's brief concludes (p. 43) with a disavowal of any approach which would "permit the leasing industry to be used as a device or a gimmick to convert ordinary income into capital gains." The law, we submit, provides no warrant for any such approach.

CONCLUSION

The judgment of the Court of Appeals should be reversed.

Respectfully submitted.

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APPENDIX A

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) [as amended by Sec. 121(c) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23(l).).

SEC. 3791. RULES AND REGULATIONS.

(a) *Authorization.*—

(1) *In general.*—Except as provided in section 1928(a), Cotton Futures, section 2599, Marihuana, section 2559, Narcotics, section 3176, Liquor, and section 1805, Silver, the Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this title.

(2) *In case of change in law.*—The Commissioner may make all such regulations, not otherwise provided for, as may have become necessary by reason of any alteration of law in relation to internal revenue.

(b) *Retroactivity of Regulations or Rulings.*—The Secretary, or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect.

(26 U.S.C. 1952 ed., Sec. 3791 (a) and (b).).

Treasury Regulations 111, promulgated October 26, 1943, under the Internal Revenue Code of 1939:

SEC. 29.23(l)-1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property determined in accordance with section 113. Due regard must also be given to expenditures for current upkeep. * * *

SEC. 29.23(l)-2. *Depreciable Property.*—The necessity for a depreciation allowance arises from the fact that certain property used in the business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply

to inventories or to stock in trade, or to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provisions for this being made in the Internal Revenue Code. (See sections 23(m) and 114.) Property kept in repair may, nevertheless, be the subject of a depreciation allowance. (See section 29.23(a)-4.) The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income. No such allowance may be made in respect of automobiles or other vehicles used solely for pleasure, a building used by the taxpayer solely as his residence, or in respect of furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be the subject of a depreciation allowance.

* * * * *

SEC. 29.23(l)-4. *Capital Sum Recoverable Through Depreciation Allowances.*—The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See sections 113(a) and 114.) To this amount should be added from time to time the cost of improvements, additions, and betterments, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property, through casualty, as distinguished from the gradual exhaustion of its utility which is the basis of the depreciation allowance. (See section 113(b).) * * *

SEC. 29.23(l)-5. *Method of Computing Depreciation Allowance.*—The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other

recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made. If the cost or other basis of the property has been recovered through depreciation or other allowances no further deduction for depreciation shall be allowed. The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, taxpayers must furnish full and complete information with respect to the cost or other basis of the assets in respect of which depreciation is claimed, their age, condition, and remaining useful life, the portion of their cost or other basis which has been recovered through depreciation allowances for prior taxable years, and such other information as the Commissioner may require in substantiation of the deduction claimed.

A taxpayer is not permitted under the law to take advantage in later years of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. * * *

APPENDIX B

Internal Revenue Code of 1954:

SEC. 167. DEPRECIATION.

(a) *General Rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) *Use of Certain Methods and Rates.*—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

(c) *Limitations on Use of Certain Methods and Rates.*—Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more—

* * * * *

(f) *Basis for Depreciation.*—The basis on which exhaustion, wear and tear and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

* * * * *

(26 U.S.C. 1958 ed., Sec. 167 (a), (b), (c) and (f).)

SEC. 7805. RULES AND REGULATIONS.

(a) *Authorization.*—Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

(b) *Retroactivity of Regulations or Rulings.*—The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

* * * * *

(26 U.S.C. 1958 ed., Sec. 7805 (a) and (b).)

Treasury Regulations on Income Taxes (1954 Code):

SEC. 1.167(a)-1. *Depreciation in general.*—(a) *Reasonable allowance.* Section 167(a)

provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and § 1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experi-

ence is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(c) *Salvage.* Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value.

Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation, or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, § 1.167(b)-2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167(b)-1, 1.167(b)-2, and 1.167(b)-3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example: The amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

* * * * *

SEC. 1.167(b)-0. *Methods of computing depreciation.*—

(a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. * * *

* * * * *

SEC. 1.167(b)-1. *Straight line method.*—

(a) *Application of method.* Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the

taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

* * * * *

Treasury Regulations 103, promulgated January 29, 1940, under the Internal Revenue Code of 1939:

SEC. 19.23(l)-1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the cost or other basis of the property determined in accordance with section 113. * * *

* * * * *

U. S. GOVERNMENT PRINTING OFFICE : 1960

BRIEF FOR

THE

RESPONDENTS

In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 143

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

ROBLEY H. EVANS AND JULIA M. EVANS,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENTS

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BRIEF FOR THE RESPONDENTS

STATUTES AND REGULATIONS INVOLVED

For the purpose of enabling the Court to compare the key portions of the depreciation regulations applicable to the years involved (Regulations 111, portions of which are reprinted in the Commissioner's opening brief, Appendix A, pages 37-38) with the analogous portions of the depreciation regulations issued in 1956, we have set forth

Reg. Sec. 1.167(a)-1(b) and 1.167(a)-1(c)—containing the Commissioner's current definitions of "useful life" and "salvage value"—at Appendix A, *infra,* pages 89-91.

QUESTION PRESENTED

During 1950 and 1951, Robley H. Evans (herein called the "taxpayer") was in the business of leasing automobiles to a corporation which in turn leased and rented them to the general public. The questions presented concern the computation of the depreciation allowances for the taxpayer's automobiles under Section 23 (l) of the 1939 Internal Revenue Code for the taxable years 1950 and 1951. Specifically, they are:

(1) Whether the "useful life" of the taxpayer's automobiles is (a) the physical or inherent functional life of such automobiles (*i.e.,* their life for general business purposes), a four-year life, as contended by the taxpayer, or (b) an average, or other imputed, period during which such automobiles happen to be held by the taxpayer, as contended by the Commissioner.

(2) Whether the "salvage value" of such automobiles is (a) the residual, junk or scrap value left in such automobiles at the end of their physical or inherent functional lives, as contended by the taxpayer, or (b) the estimated proceeds from the disposition of such automobiles which may be realized by the taxpayer based upon an assumed market value and an assumed disposition of such automobiles after an estimated period of use by the taxpayer, as contended by the Commissioner.

STATEMENT

(1) Petitioner's business.

During the years 1950 and 1951, the taxpayer was engaged in the business of leasing automobiles to Evans U-Drive, Inc. at a monthly rental of $45 per automobile. U-Drive was managed by the taxpayer, and was engaged, in Seattle, Washington, in the business of leasing and renting automobiles to the public. "Renting" refers to the hiring out of vehicles for relatively short periods, *e.g.*, by the hour or week; "leasing" refers to the hiring out of vehicles for relatively long periods, *e.g.*, for 18 to 36 months (R. 63, 64). Some of U-Drive's automobiles were leased for extended periods and the rest were rented for relatively short terms, ranging from a few hours to several weeks (R. 45, 63, 64).

Under the terms of the lease agreement between the taxpayer and U-Drive, the taxpayer was obligated to furnish U-Drive with a sufficient number of automobiles to enable it to operate and conduct its leasing and renting business efficiently. Automobiles which, from time to time, became surplus to U-Drive were returned to the taxpayer, who disposed of them at wholesale prices to used car dealers (R. 46, 48, 49).

Automobiles to be leased by U-Drive to others for extended periods of time were purchased by the taxpayer as required. At the termination or cancellation of such leases, the automobiles were returned to the taxpayer, who sold them (R. 64). When sold, such transient rental automobiles had been driven from 15,000 to 20,000 miles, whereas long-term lease vehicles had been driven as much as

50,000 miles (R. 54). The automobiles were generally in good physical condition and state of repair at the time of sale (R. 54, 58), and the taxpayer and U-Drive could have continued to use them longer than they did (R. 80-83).

The taxpayer periodically owned more automobiles than were necessary for the efficient operation of the short-term rental business of U-Drive. When this situation occurred, he would examine the cars in use and sell the number which were not needed. The oldest and least desirable automobiles were sold first (R. 51).

(2) Factors affecting purchase and sale of automobiles by taxpayer.

There was no way to predict what an automobile would bring some 18, 24 or 36 months in the future, when the lease to the customers of U-Drive terminated and the automobile might be disposed of (R. 65). It was impossible for the taxpayer to project what the sales price of an automobile was going to be when he bought it, because he never knew when he was going to dispose of it, and could not foresee 18, 12 or even 6 months ahead, the effects of the numerous economic and other factors affecting used automobile values (R. 71).

Among these factors were strike conditions, manufacturing conditions, the introduction of mechanical innovations, the advent of war and the anticipation of rationing (R. 66, 69, 71).

During the years 1950 and 1951, the taxpayer disposed of certain automobiles used in his business at the respective times and for the respective prices set forth in the Com-

missioner's Exhibits B and C (R. 129-135), the taxpayer having purchased these automobiles at the respective dates and for the respective prices set forth in said Exhibits.

(3) Accounting practice as to "useful life" and "salvage value."

Certified public accountants—partners, respectively, in the firms of Ernst & Ernst and Price Waterhouse & Co.—testified that "useful life" has consistently meant and still means, for both accounting and federal income tax purposes, not the period of use of an asset in the hands of the taxpayer, but the economic life, the general business life, of the asset in whatever hands (R. 83-91). (The uncontradicted testimony at the trial in the Tax Court was that such economic life is four years [R. 70].) The accountants testified that "salvage value" has meant for tax and accounting depreciation purposes the scrap or junk value remaining in the asset when its usefulness has been exhausted after such general business life, and not the resale value of the asset upon its sale by a particular taxpayer for use by somebody else (R. 85, 87, 89).

(4) The taxes here involved.

During the years in issue, the taxpayer depreciated his automobiles at the rate of 25% per annum without any allowance for salvage value. This rate represented a four-year useful life, and resulted in deductions in the amounts of $77,972.71 and $92,890.05 for the years 1950 and 1951, respectively (R. 22). Such amounts were deducted pursuant to the provisions of Section 23(l) of the 1939 Code, applicable to the years in issue.

On March 9, 1955, the Commissioner sent the taxpayer a statutory notice of deficiency, alleging, among other things, that the taxpayer had overstated the 1950 and 1951 depreciation deductions allowable with respect to his automobiles. In that notice, the Commissioner recomputed depreciation for the years 1950 and 1951 in the respective amounts of $21,858.62 and $30,374.13, stating that the average useful life of automobiles in the taxpayer's business was not in excess of seventeen months and the average salvage value of said automobiles was not less than $1,325.00 or the adjusted basis of said automobiles as of January 1, 1950, whichever amount was the lesser (R. 12).

In computing the rate of depreciation for his automobiles, the taxpayer used their physical or inherent functional life (*i.e.,* their life for general business purposes)—four years. In the notice of deficiency, the Commissioner claimed that the "useful life" of the taxpayer's automobiles should be determined not on the basis of their physical or inherent functional life but rather on the basis of the average period during which the taxpayer held them (R. 12). The Commissioner also claimed that the salvage value of such automobiles should be determined for the years in issue by taking the average of the amounts realized by the taxpayer from the disposition of his automobiles during those years (R. 12).

(5) The proceedings below.

The taxpayer petitioned the Tax Court for a redetermination of the proposed deficiency, and trial was held in Seattle on February 5, 1957. On July 31, 1957, the

Tax Court filed a memorandum opinion (R. 24-33) holding that the taxpayer's automobiles used under extended term leases had a useful life of three years and a salvage value of $600, and that the taxpayer's automobiles used in short-term rentals had a useful life of 15 months and a salvage value of $1,375. With respect to the salvage value issue, the Tax Court further held that if the "undepreciated cost" (apparently meaning adjusted basis) of the automobiles in service at January 1, 1950, was less than $600 and $1,375 for the respective classes of automobiles, those amounts should be the salvage value of those automobiles. The Tax Court apparently adopted, without discussion, the Commissioner's definitions of useful life and salvage value. Pursuant to the Tax Court's opinion, a decision was entered under Rule 50 of the Rules of the Tax Court on February 7, 1958 (R. 34), adjudging a total deficiency of $26,239.64 for the years 1950 and 1951, of which $23,139.12 is attributable to the issue here involved—the taxpayer's deductions for automobile depreciation. (The balance of the deficiency, already paid, was attributable to issues settled by stipulation.)

On appeal, the Court of Appeals for the Ninth Circuit reversed and remanded, holding that the Tax Court had applied erroneous definitions of "useful life" and "salvage value"; that "useful life" meant the entire period of economic usefulness of the asset, not the period of use in a particular taxpayer's business; and that "salvage value" accordingly meant the value remaining in the asset at the end of "useful life" so defined, not the proceeds realized from the sale or other disposition of the asset when it was no longer useful in the business of the particular taxpayer (R. 115).

SUMMARY OF ARGUMENT

The useful life of an asset determines the annual rate of depreciation. (Thus, an asset with a four-year useful life is depreciated at the annual rate of 25% of the depreciable amount.) It follows that precise definition of the term "useful life" is fundamental to a determination of depreciation.

But that term was neither used in, nor defined by, the 1939 Code (applicable to the years here in issue) or any of the prior revenue acts. Likewise, the Commissioner's regulations from 1918 to 1956 fail to provide a definition.

Accordingly, we must look elsewhere to determine the meaning of "useful life". From the first of the federal income tax statutes, the useful life of property, for depreciation purposes—as clearly appears from the judicial decisions, the Treasury's administrative practices and pronouncements, and the practices of the business community as evidenced by expert accounting testimony—has meant the physical or inherent functional life of the property (*i.e.*, the property's life for general business purposes), and not the period during which it is estimated it will be held by a particular taxpayer in his business. This was the opinion of the Ninth Circuit below.

The authorities hereinafter discussed fully support taxpayer's use of a four-year life for depreciating automobiles used in business. Instead, the Commissioner has urged the adoption of his new definition of "useful life" as the taxpayer's holding period. However, he has failed to cite a single relevant authority in support of that definition. In the absence of such authority, he appears to be attempting to apply his new regulations (promulgated in June, 1956, under the 1954 Code) to this case, involving the taxable years 1950 and 1951 (264 F. 2d 506; R. 106).

Salvage value is the reciprocal of useful life. The salvage value of an asset under any definition of useful life is a residual value—the asset's value upon the completion of the depreciation process. Thus "salvage value", for depreciation purposes, means the residual, junk or scrap value of property remaining at the end of its full "useful life"—its inherent functional life for business purposes. It is not the estimated market value which may be realized at the unpredictable time when a given taxpayer may decide to sell or otherwise dispose of the property before the end of its useful life. The courts and the Commissioner himself have consistently negated market value as a factor in determining salvage value, rejecting market value as an element in determining depreciation rates or amounts.

What the Commissioner is trying to do here is to trim the depreciation deduction at both ends: greatly to reduce the actual depreciable life of an automobile and, by calling the resale value of the automobiles their salvage value, greatly to reduce the amount which can be deducted.

The Commissioner's true objective here, in defiance of Congressional purposes, is to prevent taxpayers from availing themselves of capital gains on sale of business assets under Section 117(j) of the 1939 Code (now Section 1231 of the 1954 Code), in force since 1942. Having failed in other, more direct, attempts to accomplish this end, the Commissioner has apparently decided on another approach, exemplified by this case. This approach requires him to upset the long-accepted definitions of "useful life" and "salvage value".

As belatedly admitted by the Treasury's letter of February 12, 1960 (Appendix B, *infra*), the policy changes which the Commissioner wants must be made by legislation.

ARGUMENT.

I.

THE USEFUL LIFE OF AN ASSET FOR FEDERAL INCOME TAX DEPRECIATION PURPOSES HAS ALWAYS BEEN DEFINED AS THE PHYSICAL OR INHERENT FUNCTIONAL LIFE OF THE ASSET (i.e., ITS LIFE FOR GENERAL BUSINESS PURPOSES), AND NOT A SHORTER PERIOD DURING WHICH A PARTICULAR TAXPAYER MAY HAPPEN TO HOLD SUCH ASSET.

The issues in the case at bar—indeed, in our view, the fact that there is a case at all—hinge upon this fundamental point in the federal income tax law: As a taxpayer deducts each dollar of the statutory depreciation allowance for "exhaustion, wear and tear" of a depreciable business property (Section 23(l) of the 1939 Code), the basis for determining gain or loss on the sale of such property is reduced by the same dollar (Section 113[b][1][B] of the 1939 Code). If the taxpayer then happens to sell the property, after more than six months, in a market favorable enough to give him a price greater than the property's cost basis *so reduced by depreciation,* the differential is taxable, but at the capital gains maximum rate of 25% instead of the applicable (and higher) ordinary rate. That is the result prescribed by Section 117(j) of the 1939 Code (Section 1231 of the 1954 Code), in force since 1942.

As we shall show, the present proceeding is the most recent in a series of attempts by the Treasury to overcome

or minimize the beneficial rate granted by Section 117(j). And we think it important to emphasize at the outset the following:

(1) The Commissioner's deficiency notice to Mr. and Mrs. Evans asserted not only the conceptions of useful life and salvage now in issue before the Court, but also made the following claim:

> "It is further held that you were also in the business of selling used automobiles during the years 1950 and 1951. Consequently, the profit realized from the sale of the automobiles was income from the sale of property held primarily for sale in the ordinary course of your business within the meaning of section 117(j) of the Internal Revenue Code and such income may not be treated as a capital gain under the above-mentioned section of the Code" (R. 12).

After trial, the Commissioner conceded the error of that contention, saying:

> "Respondent [Commissioner] concedes the issue of whether the automobiles sold in 1950 and 1951 were held for sale to customers in the ordinary course of business, and agrees that such sales may be treated as sales of property used in the taxpayers' trade or business within the meaning of section 117(j) of the Internal Revenue Code of 1939" (Page 1, Brief for the Respondent in the Tax Court, Docket No. 58067).

(2) Government counsel admitted at the trial that the Government's position—

> ". . . is *somewhat in the alternative* because we have adjusted the useful life and we have ad-

justed the depreciation and *in taking that action* we have cut down the amount of gain or profit considerably" (R. 40, emphasis added).

(3) All that remained was for the Commissioner to say, as he now has, "The question in this case bears upon the proper computation or determination of capital gain" (Brief for the Petitioner, page 11).

In the light of what we believe to be the Commissioner's true motive in raising the depreciation issues in this case—to attempt once more to limit the capital gains treatment under Section 117(j) of the 1939 Code—we shall demonstrate that the term useful life means and has been understood to mean the physical or inherent functional life of the asset. A fuller discussion of the Commissioner's attitude toward Section 117(j) of the 1939 Code and his previous attempts to limit its application may be found beginning page 71, *infra*.

The present dispute[1] arises in spite of judicial interpretation, administrative practices and pronouncements under the 1939 Code and prior revenue acts and accounting practices (confirmed by expert opinion), all of which confirm that for purposes of the depreciation deduction "useful life" means the period during which an asset is physically

[1] The current depreciation litigation—involving several cases dealing with useful life and salvage value—seems clearly to have been inspired by the Commissioner's resistance to the allowance of capital gains on the sale of property depreciated under the new methods permitted by Congress in Section 167 of the 1954 Internal Revenue Code. See *The Hertz Corporation* v. *United States*, 268 F. 2d 604 (3rd Cir., 1959), No. 283, this Term, certiorari granted October 12, 1959.

useful for business purposes, rather than the shorter period during which it happens to be owned by a particular taxpayer.

As we shall show, until promulgation of the 1956 depreciation regulations, the definition of "useful life" which was "part and parcel of the actual and effective administration of the . . . tax statute"[2] was: the life of the asset during which it still has usefulness, and not just the period during which it is held by a given taxpayer until, for reasons perhaps completely unconnected with the newness, oldness or *usefulness* of the asset, it is sold or otherwise disposed of.

Under the Commissioner's new view of useful life, contradictory and confusing results would ensue. For example, let us consider the case of two taxpayers who are in the same type of business and who buy—at the same time and at the same price—an identical asset. (Let us assume also the same degree of physical usage and wear and tear, and the same inspection and repair procedures.) Suppose that the two taxpayers accurately estimate their holding periods differently—all else being the same.

Under the Commissioner's definition of useful life in this case, depreciation will be computed differently for the two taxpayers in the above example, despite the fact that the assets involved will be undergoing exactly the same rate of "exhaustion, wear and tear" contemplated by the statute. Thus, the underlying statutory definition

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[2] *Jackson Finance and Thrift Co. v. Commissioner of Internal Revenue*, 260 F. 2d 578, 581 (10th Cir., 1958).

of depreciation would be changed from "exhaustion, wear and tear" to something indeterminate—some combination of exhaustion, wear and tear and other considerations foreign to and unconnected with the wearing out of the assets and the direction of the statute.

The following table traces briefly the basic depreciation provision of the 1939 Code and prior revenue acts, and shows the stability of this provision over a period of 41 years—from 1913 to 1954:

Depreciation Provision	Statute
"A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business".	Subdivision B, sixth, Revenue Act of 1913 (38 Stat. 114 [1913])
"A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade".	Section 5(a) seventh, Revenue Act of 1916 (39 Stat. 756 [1916]); and Section 5(a) seventh, Revenue Act of 1917 (39 Stat. 756 [1916]), as amended by Act of October 3, 1917 (40 Stat. 300 [1917]).
"A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business including a reasonable allowance for obsolescence"	Section 214(a)(8), Revenue Acts of: —1918 (40 Stat. 1057 [1919]), —1921 (42 Stat. 227 [1921]), —1924 (43 Stat. 253 [1924]). Sections 214(a)(8) and 234(a)(7) of Revenue Act of 1926 (44 Stat. 9 [1926]). Section 23(k), Revenue Acts of: —1928 (45 Stat. 791 [1928]), —1932 (47 Stat. 169 [1932]). Section 23(l), Revenue Acts of: —1934 (48 Stat. 680 [1934]). —1936 (49 Stat. 1648 [1936]), —1938 (52 Stat. 447 [1938]). Internal Revenue Code of 1939 (53 Stat. 1 [1939]).
"A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)— (1) of property used in the trade or business, or (2) of property held for the production of income."	Section 23(l), Internal Revenue Code of 1939, as amended by the Revenue Act of 1942 (56 Stat. 798 [1942]), and as in force up to the effective date of Section 167 of the 1954 Internal Revenue Code.

These statutory provisions do not mention "useful life", let alone define it.

Running parallel with this constant statutory provision were basic regulations on depreciation which also remained virtually unchanged in all respects material to the present case, from 1918 to the date on which the Commissioner issued his new 1956 regulations. Those regulations are important because they mention "useful life". A succinct description of all of the relevant depreciation regulations which had been in force before Congress addressed itself to the 1954 Code appears in the Ninth Circuit's opinion below (264 F. 2d at 507, 508; R. 108, 109):

> "The first appearance of the [term] 'useful life' . . . in Treasury Regulations was in Treasury Regulations 45, Article 161 (1919), effective for the calendar years 1918-19 and 1920. Article 161 provided in part, as follows: 'The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the *useful life of the property in the business* will suffice, with the salvage value, at the end of such useful life to provide in place of the property its cost * * *' (Emphasis added)
>
> "Article 165 of the same Regulations provided in part, as follows: 'The capital sum to be replaced *should be charged off over the useful life of the property* * * *' (Emphasis added)
>
> "Similar wording with changes not material to the problem before us appeared in subsequent Treasury Regulations through Regulations 103, Section 12.23

> (l)-1-5, effective for the tax years 1939-40 and 1941. The words 'in the business' which appeared in Article 161 of Regulations 45 continued to appear in successive regulations until the issuance of Regulations 111 in 1942. No definition or further explanation of the [term] 'useful life' . . . appeared in any of the regulations to which reference has been made until the issuance of Treasury Regulations T.D. 6182, promulgated under the 1954 Revenue Code. The [term] 'useful life' . . . [is] not defined or explained in Regulations 111. The language of the Regulations does not limit 'useful life' to the useful life of the depreciable assets in the business of the taxpayer or to the period during which such assets are held by the taxpayer."

Thus, neither the basic depreciation statutes nor the Commissioner's regulations defined the term useful life. In the absence of such statutory or regulatory definition, we now turn to the customary precedents—the cases, the Commissioner's pronouncements and the practice in the accounting profession over a period of many years (as evidenced by expert opinion). The precedents established, in the opinion of the Ninth Circuit below, that for purposes of depreciation deductions "useful life" means the physical or inherent functional life of the property, and not the intended or actual period of the taxpayer's use of the property.

As the Court will observe in the authorities discussed below, a striking feature of the legal history of that phrase over the years is the vigor with which the Commissioner himself pressed the definition for which the taxpayer here contends.

1. *The prior cases.*

The principle that "useful life" means the business life of the asset itself, and not the period such asset is held by a specific taxpayer, has long been recognized by the courts.

In *Sanford Cotton Mills,* 14 B.T.A. 1210 (1929), Acq. X-2 CB 63, the taxpayer, a manufacturer of cotton sheeting, contested the Commissioner's reduction of the rate of depreciation of motor trucks from 33-⅓% (three-year life) to 20% (five-year life). The taxpayer made a practice of keeping the trucks approximately 2½ years. The Board of Tax Appeals nevertheless held that a rate of 25% (four-year life) was reasonable.

In *Merkle Broom Co.,* 3 B.T.A. 1084 (1926), Acq. V-2 CB 2, which concerned the proper depreciation rate for the taxpayer's fleet of automobiles used by its salesmen, the taxpayer claimed 33-1/3% per annum (three-year life) and the Commissioner allowed 20% per annum (five-year life). Although the Board of Tax Appeals found that the taxpayer renewed its fleet every second year, it nevertheless held that the proper rate for depreciation was 25% (four-year life).

In *Max Kurtz, et al.,* 8 B.T.A. 679 (1927), Acq. VII-1 CB 18, the taxpayer contested the Commissioner's determination of a five-year useful life for business automobiles and trucks which the Board of Tax Appeals found were traded in by the taxpayer after two or three years of use. Yet the Board held:

> "The Board is of the opinion that, upon consideration of all the evidence, the Commissioner's allowance for exhaustion, wear and tear of automobiles at the rate of 20 per cent per annum was reasonable." (8 B.T.A. at 683.)

The Commissioner officially acquiesced in these decisions.

In *General Securities Co.*, B.T.A. Memo, CCH Dec. 12,500-D (1942), *aff'd per curiam* on another issue, 137 F. 2d 201 (6th Cir. 1943), the facts with respect to the depreciation issue were found by the Board of Tax Appeals as follows:

> "In its business petitioner used one or two automobiles in which its agents traveled over territory located in all of the southern states. Each automobile traveled some 60,000 to 75,000 miles a year. *Petitioner kept his automobiles from one to two years.* When petitioner traded its cars in after one year, from a value standpoint, they had a third to a half of their original value left. *The normal useful life of automobiles used by petitioner in its business was three years.*" (B.T.A. Memo, CCH Dec. 12,500-D at 37,941; emphasis added.)

Again, the Commissioner in that case was contending for a longer useful life for petitioner's automobiles than the three years used by petitioner in computing its depreciation. Neither the parties nor the Board of Tax Appeals considered it proper to equate the automobiles' useful life with the taxpayer's one- or two-year period of ownership.

In each of the foregoing cases the Commissioner took the position that the useful life of the automobiles was a

period substantially longer than the taxpayer's customary holding period.

As early as 1916, the court in *Cohen* v. *Lowe, Collector*, 234 Fed. 474, 476 (D.C.S.D. N.Y., 1916), stated:

> "[The depreciation allowance] is to be based upon the life of the building, in the sense of the number of years the building would remain in a condition to be habitable for the uses for which it was constructed and used. . . ."

Other cases which similarly illustrate the traditional distinction between an asset's useful life and the periods during which it happens to be used by a particular taxpayer in his business are: *West Virginia & Pennsylvania Coal & Coke Co.*, 1 B.T.A. 790, 792 (1925); *J. R. James*, 2 B.T.A. 1071, 1072 (1925), Acq. V-1 CB 3; *Wallace G. Kay*, 10 B.T.A. 534, 535 (1928), Acq. VII-1 CB 17; *W. N. Foster, et al.*, 2 TCM 595, 597 (1943); *John A. Maguire Estate, Ltd.*, 17 B.T.A. 394, 399 (1929), Acq. IX-1 CB 34; *Nat Lewis*, 13 TCM 1167, 1170 (1954); and *Whitman-Douglas Co.*, 8 B.T.A. 694, 697 (1927).

The Commissioner argues (Brief for the Petitioner, page 26, footnote 15) that in the cases discussed above the issue was not squarely presented nor was any theory of useful life presented. The Commissioner is mistaken. The proper meaning of useful life was fundamental to the decision in each of those cases, since the question in each case was the proper depreciation deduction. For this purpose it was necessary to know the useful life, and this was

determined in terms of how long the asset would last.[3] Furthermore, the Ninth Circuit in ~~its~~ opinion below found that the issue was squarely presented, saying:

> "Further evidence of the position of the Commissioner is drawn from his acquiescence in decisions of the Board of Tax Appeals which measured 'useful life' of the depreciable asset not by the holding period of such asset by the particular taxpayer, but by the economic or physical life of such asset." (264 F. 2d at 509; R. 110.)

Having demonstrated that the cases in which a determination of the depreciation deduction was in issue required a determination of the useful life of the assets depreciated, and that useful life was invariably defined to mean physical or inherent functional life, we shall now consider the cases which the Commissioner suggests have reached a different result.

The Commissioner has attempted to wrest, from certain dicta of this Court, support for his new definition of useful life (Brief for the Petitioner, pages 15-16, 19-22). This

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[3] This is borne out by an examination of the underlying briefs and records. For example, in *Max Kurtz, et al.*, 8 B.T.A. 679 (1927), Acq. VII-1 CB 18, the transcript of testimony (pages 41-43) shows questioning directed to finding out "How long [the] equipment would last under [given] conditions"; in *Sanford Cotton Mills*, 14 B.T.A. 1210 (1929), Acq. X-2 CB 63, the petitioner's brief (pages 6-7) squarely posed the question of how long the automobiles would "last".

It should also be noted that in a number of the cases cited above, the Commissioner has officially acquiesced in decisions which defined useful life for depreciation purposes as meaning the business life of the asset irrespective of the taxpayer's holding period.

attempt centers around *United States* v. *Ludey*, 274 U.S. 295 (1927),[4] and certain language which appeared in the Treasury's depreciation regulations from 1918 to 1942, but which did not appear there during the years in issue —1950 and 1951. We believe that attempt is completely inconclusive, for the following reasons:

(a) The Commissioner basically relies on the following single sentence in *Ludey* (274 U.S. at 300-301):

> "The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost."

That statement was unnecessary in the determination of the case. All that *Ludey* decided was that the deductions for depreciation and depletion (the amounts of which were uncontroverted) to which the taxpayer was entitled should be subtracted from original cost in determining the basis of certain oil properties at the time of sale. There was no dispute as to the *method* of depreciation or depletion (274 U.S. at 297). Furthermore, a number of the cases cited above were decided after the 1927 decision in *Ludey*, and, indeed, the Commissioner acquiesced in a number of them.

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[4] The only other decision of this Court on which the Commissioner places any emphasis (Brief for the Petitioner, page 16) is *Detroit Edison Co.* v. *Commissioner of Internal Revenue*, 319 U.S. 98 (1943). An examination of the opinion, record and briefs in that case fails to disclose anything which appears to be helpful in the disposition of the issues at bar.

(b) The phrase "useful life of the property in the business" (which appeared in the depreciation regulations from 1918 to 1942) did not appear in the regulations applicable to the taxable years in question, which, instead, referred to "useful life of the depreciable property" (Regulations 111, Sec. 29.23(l)-1). The term "in the business" as it appeared in the regulations from 1918 to 1942, had the sole purpose of defining the nature or type of assets which could be depreciated by a taxpayer, that is, property devoted to business, or, simply, business property. It is clear that the term did not mean and never was intended to be a limitation on the period during which business assets could be depreciated.

The Ninth Circuit below properly assessed the language change in the regulations when it stated (264 F. 2d at 508; R. 109):

> "The significance, if any, to be attached to the omission of the words 'in the business' from Regulations 111 is obscure. We attach no significance thereto because in our view the practice and position of the Commissioner has been the same under Regulations 45 and succeeding regulations up to T.D. 6182 [the depreciation regulations issued in June, 1956], except for a few recent cases under Regulations 111 of the Internal Revenue Code of 1939, in which the Commissioner asserted the concepts of 'useful life' and 'salvage value' embodied in T.D. 6182.
>
> "From the practice of the Commissioner over the years, it appears to us that the phrase 'in the business' included in earlier regulations simply

defined the type of assets which were subject to the depreciation allowance. The omission of such phrase from Treasury Regulations 111 would not furnish the basis for an interpretation of the term 'useful life' which it did not have when the phrase appeared in the regulations."

(c) The Commissioner argues (Brief for the Petitioner, page 22, footnote 14): "In view of the fact that a specific detailed definition of depreciable property was contained in Section 19.23(l)-2 [of Regulations 103, effective for 1939-41], the use of the words 'in the business' in Section 19.23(l)-1 undoubtedly was intended to have a function other than that of mere definition. And this function, we submit, was to limit the concept of 'useful life' to that time during which the property was useful 'in the business' of the taxpayer."

The Commissioner's inference appears totally unjustified, however, when it is realized that Regulations 111, applicable to the years in issue, contain the following provision:

> "The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income." (Reg. 111, Sec. 29.23(l)-2, in part.)

The entire portion of this sentence beginning with "or treated" was added by T.D. 5196, 1942-2 CB 96, 100, after Section 121(c) of the Revenue Act of 1942 (56 Stat. 798, 819) added "property held for the production

of income" to the items on which depreciation could be deducted. Thus, "used in the . . . business" and "held . . . for the production of income" were simply parallel definitions of the two basic types of assets depreciable after the 1942 statutory amendment. "Useful life of the property in the business" in the pre-1942 regulations (and in *Ludey*) was the generic phrase used to describe the kind of property which could be depreciated, just as "useful life of the depreciable property" in the 1942-and-following regulations merely enlarged the generic class of such property, as required by the 1942 change in the statute.

Accordingly, "in the business" did not have the function of limiting the definition of useful life to a taxpayer's period of use, as lately claimed by the Commissioner.

The Commissioner's claim that his present view of useful life has always been the law makes his citation of the other cases listed at page 16 of the Brief for the Petitioner somewhat puzzling. For if those cases—which are so clearly far afield—represent the best authorities for his position which he has been able to find, his conclusion that his position "accords with the authorities" (brief, page 9) would seem to be without foundation.

A review of the Commissioner's "authorities" discloses the following:

Gambrinus Brewery Co. v. Anderson, 282 U.S. 638 (1931), merely allowed an obsolescence deduction to a brewery owner, for the taxable years 1918 and 1919, for

buildings which were specially constructed for brewery purposes, were not commercially adaptable for any other use and thus were rendered valueless by the onset of national prohibition. These points are irrelevant here.

Virginian Hotel Corp. v. *Helvering*, 319 U.S. 523 (1943), held that the basis of depreciable property is reduced by the amount "allowable" each year, whether or not claimed by the taxpayer. The point is not at issue here, and certainly is not disputed by the taxpayer.

Cohn v. *United States*, 259 F. 2d 371 (6th Cir. 1958) is discussed at pages 28, 42-43 and 62-63 herein.

Becker v. *Anheuser-Busch, Inc.*, 120 F. 2d 403 (8th Cir. 1941), certiorari denied 314 U.S. 625 (1941), concerned a special argument on the alleged obsolescence of beverage bottles and cases incident to the onset of national prohibition. These bottles and cases, held the court, would produce a loss for tax purposes only upon final disposition (120 F. 2d at 148). Like *Gambrinus Brewery*, above, this holding is unexceptionable and irrelevant here.

Burlington Gazette Co. v. *Commissioner of Internal Revenue*, 75 F. 2d 577 (8th Cir. 1935), stands for the proposition that annual depreciation deductions may not aggregate more than the cost of the asset. We do not dispute this.

Cameron v. *Commissioner of Internal Revenue*, 56 F. 2d 1021 (3rd Cir. 1932), decided that a change in personnel of a partnership did not create a new partnership, new assets or a new depreciation rate on those assets; that the Board of Tax Appeals was justified in its finding of the March 1, 1913 value of certain depreciable assets; and that the taxpayer could not continue claiming deprecia-

tion deductions after the deductions equaled his original cost. None of these points is relevant here.*

It is apparent, therefore, not only that the holdings in *Ludey* and the other cases cited by the Commissioner are of no value in resolving the issues in this case, but also that the language in *Ludey* from which the Commissioner attempts to gain support for his position is irrelevant.

We shall now turn to recent decisions in which the Commissioner took a position wholly inconsistent with his views in the present case—a position which supports that of the taxpayer herein.

2. *Recent Decisions*

Philber Equipment Corporation v. *Commissioner of Internal Revenue,* 237 F. 2d 129 (3d Cir. 1956), provides judicial corroboration (as well as the Commissioner's own assertion) of the principle that a taxpayer's holding period of leased vehicles (trucks, trailers and tractors) does not determine their useful life. There, the taxpayer regularly disposed of such vehicles after the end of one-year terms during which they were leased to taxpayer's customers. Thus, the lease period and the taxpayer's holding period were the same. The court stated:

> "Taxpayer knew that when equipment was purchased, it would probably be able to rent the equipment for a *period substantially less than its useful life,* and sale of the equipment would follow expiration of a lease." (237 F. 2d at 130; emphasis added.)

And the Commissioner specifically argued to the same effect in his brief, where he stated:

> "**Because of existing conditions taxpayer knew when it purchased equipment that it would likely be able to rent such equipment only for a *period that was substantially less than its useful life.*" (Brief for Respondent, p. 5, *Philber Equipment Corporation* v. *Commissioner of Internal Revenue,* (3d Cir.), Docket No. 11,860; emphasis added.)**

And again, at page 11 of the Commissioner's brief in that case, he stated:

> "**. . . all of the leases involved were only for a one-year term, *a period substantially less than the useful life* of this type of equipment as its resale in the tax years and re-lease in later years demonstrates." (Emphasis added.)**

Here is a clear recognition by the Commissioner, in 1956, of the accepted meaning of useful life, directly contradicting the Commissioner's position in the case at bar.[5]

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[5] Similarly, in *Cohn* v. *United States,* 259 F. 2d 371 (6th Cir. 1958), cited by the Commissioner in his opening brief in this Court (page 16), the taxpayers bought equipment in 1941 and 1942 for use in Army Air Corps flying schools, estimating that the equipment would no longer be useful in those enterprises after December 31, 1944. (The schools were actually terminated in August and October, 1944.) Nevertheless, the Commissioner asserted deficiencies on the basis of a ten-year life for some assets and a five-year life for others (259 F. 2d at 374-75). That action is certainly in direct conflict with the Commissioner's present view of useful life.

It should also be noted that in *Cohn,* when the taxpayers cited provisions of the 1956 depreciation regulations which they deemed beneficial to them, the Commissioner did not hesitate to say:

> "At the outset, it should be noted that these Regulations [the 1956 regulations] are applicable only to years involved under the Internal Revenue Code of 1954 and not to the years involved here, which are covered by the provisions of Treasury Regulations 111." (Brief and Appendices for the Appellee, Docket Nos. 13,360-13,362, page 26.)

We refer the Court also to *Pilot Freight Carriers, Inc.*, 15 TCM 1027 (1956), in which the taxpayer's tractors and trailers were shown to have been held by the taxpayer for average periods of 38 months and 32.6 months, respectively. Nonetheless, the court held that the useful lives of such tractors and trailers, for depreciation purposes, were, respectively, four years (instead of 38 months) and five years (instead of 32.6 months). Despite the holding periods shown, the Commissioner had actually *asserted and was contending for deficiencies* on the basis of *five- and six-year useful lives, respectively.*[6]

In addition, recent decisions of the United States District Court for the Southern District of Florida and the Tax Court confirm in all respects the plaintiff's view of useful life—*Davidson* v. *Tomlinson,* 165 F. Supp. 455 (D.C. S.D. Fla. 1958), and *Lynch-Davidson Motors, Inc.* v. *Tomlinson,* 172 F. Supp. 101 (D.C.S.D. Fla. 1958), both on appeal to the Fifth Circuit.

In *Charlie Hillard,* 31 T.C. 961 (1959), also on appeal to the Fifth Circuit, the Tax Court confirms plaintiff's view of the meaning of useful life under the 1939 Code. There, the taxpayer was in the rent a car business. On the issue of depreciation allowable for periods during which taxpayer's automobiles were held for rental purposes, Judge Raum stated:

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[6] The briefs in *Pilot Freight Carriers* (which was decided *after* promulgation of the 1956 depreciation regulations) show an explicit submission to the Tax Court of the conflicting views of the meaning of useful life. (See Commissioner's brief, Docket No. 53266, pages 29-30.)

"Petitioner, in his returns, originally treated the rental cars as having a normal useful life of *3 years;* and the Commissioner's determination, agreed to by petitioner, fixed that period at *4 years. Yet, it was petitioner's practice to sell the cars after they had been in use for only about a year.* Thus, when he purchased the cars in the first instance it was plainly his intention to use them in the rent-a-car operation *for a comparatively minor portion of their useful life and then to sell them.*" (31 T.C. at 969; emphasis added.)

We note two things about this case: First, despite the fact that taxpayer sold the cars after they had been in use only about a year, not only did the Commissioner fail to contend that their useful life was a year, but he actually *extended* the claimed three-year life to four years (which, we note, is the only useful life for automobiles sustained by the record in the instant case); and, second, the Tax Court noted, as did the Third Circuit in the *Philber* case, that the holding period of the vehicles was only a small part of their useful life.

Thus, in a parade of litigated cases from 1916 to 1959 there has been implicit in the Commissioner's position—and very frequently he has been most explicit about it—the proposition that useful life means economic physical life, not just a given taxpayer's period of use. In those cases, the Commissioner has given the word "useful" its actual meaning of "able to be used," "fit to be used," or "capable of use", rather than any strained and unsupported definition such as "retained for use", "held for use", or "still usable but not yet sold or otherwise dis-

posed of." In those cases, he has apparently recognized also that the word "life" is far less consistent with any concept of holding period than it is with viable existence. "Life" is something which ends in death, or disintegration or at least absence of *usefulness*—not something which ends with a transfer to other hands for still further use. "Useful life" means today exactly what it has always meant—except for a 1956 Treasury regulation and the Commissioner's current contentions, which try to engraft a new and inconsistent meaning on a well-understood phrase.

The Fifth Circuit's recent non-unanimous decision in *United States* v. *Massey Motors, Inc.*, 264 F. 2d 552 (5th Cir. 1959), No. 141, this Term, certiorari granted October 12, 1959, is plainly distinguishable on the facts, and is, moreover, erroneous in its statement of the governing legal principles, for the following reasons:

(i) The plaintiff in that case was a new car dealer who "temporarily assigned" new cars for use as executive cars and rental cars. The court referred to the cars as "bought by him for sale but temporarily assigned for use in the business", pointed out that the executive cars in issue were sold for $11,272.80 more than their cost and the rental cars in issue for $525.84 more than their cost, and added that "it is quite doubtful that Congress ever intended that automobiles temporarily used by people in the business of selling automobiles should be subject to depreciation at all". The Fifth Circuit was simply using the depreciation provisions to eliminate what it regarded, on the facts, as a loophole under Section 117(j) of the 1939 Code. But in the case at bar, the taxpayer was not a dealer, did not temporarily assign vehicles to rental duty, and

certainly did not, at the conclusion of the lease or rental cycle, sell them for more than it paid for them.

(ii) The Fifth Circuit expressed disappointment (footnote 1 to its opinion) with the Government's concession that the plaintiff was not a "dealer" within the meaning of Section 117(j), and then proceeded to repair the damage by its depreciation decision.

(iii) The Fifth Circuit refers to a special line of cases involving automobile dealers, including *Johnson-McReynolds Chevrolet Corporation,* 27 T.C. 300 (1956); *W. R. Stephens Co.* v. *Commissioner of Internal Revenue,* 199 F. 2d 665 (8th Cir. 1952); and *Latimer-Looney Chevrolet, Inc.,* 19 T.C. 120 (1952). The facts in those dealer cases are far removed from those in the instant case, as the Commissioner has himself recognized in Rev. Rul. 54-229, 1954-1 CB 124, discussed below at pages 38-39, to which we direct the Court's special attention, and Rev. Rul. 60-15, I.R.B. 1960-3, 9.

(iv) The Fifth Circuit refers to the Commissioner's defeat on the capital gains issue in some of the automobile dealer cases, and states:

> "When he [the Commissioner] lost that argument he then issued new regulations [the 1956 regulations] which do precisely cover this type of property as used here. In doing so he did not intend to and did not—he *could* not—change the law. For us to hold that the new regulations of 1956 had the effect of defining useful life as useful life in the business for the first time would amount to our saying that the Commissioner could by Regulations change the law." (264 F. 2d at 559.)

Not only is the Fifth Circuit's opinion devoid of any real argument or citation to support this conclusion

but the conclusion itself appears to us to reduce to this syllogism:

a. We cannot uphold regulations which change the law.

b. We are upholding these regulations.

c. Therefore, these regulations do not change the law.

3. *The Commissioner's own pronouncements.*

Nowhere in the Commissioner's pronouncements before he issued the 1956 depreciation regulations has he indicated the result for which he now contends. Instead, his pronouncements were entirely consistent with the taxpayer's contention and with what taxpayers generally have assumed is useful life for depreciation purposes, namely, general life for business purposes.

Thus, in O.D. 845, 4 CB 178 (1921) (still in full force and unmodified), the Treasury Department took the position that the term "useful life" means "the period of time over which an asset *may be used* for the purpose for which it was acquired. In the case of a new building, this period starts at the time the building is completed and *capable of being used.*" (Emphasis added.) It should be noted that there are no words of limitation and that this interpretation is in terms of the usability of the asset itself for general business purposes, without consideration of whether the particular taxpayer uses it up himself or sells it before the end of such usability. Not only does "useful life" begin when the building is first "capable of being used," but, likewise, its useful life ends when the building no longer "may be used."

Bulletin "F", revised January, 1942,[7] is a bulletin issued by the Treasury Department (reprinted in 1959 by the Government Printing Office), reciting on its title page that it contains information and statistical data relating to the determination of deductions for depreciation " . . . from which taxpayers and their counsel may obtain the best available indication of Bureau practice and the trend and tendency of official opinion in the administration of pertinent provisions of the Internal Revenue Code. . . . "

For many years before the taxable years here under review, the Treasury Department's Bulletin "F" has stated as the first portion of its Introduction:

> "The Federal income tax in general is based upon net income of a specified period designated as the taxable year. The production of net income usually involves the use of capital assets *which wear out, become exhausted, or are consumed in such use. The wearing out, exhaustion, or consumption* usually is

[7] In the official reprint of Bulletin "F" in 1955 (IRS Publication Number 173), which reprinted tables of useful lives exactly as in the January, 1942 revision of Bulletin "F", appeared the statement that taxpayers should understand that "the useful lives shown are not mandatory" and that "taxpayers may determine reasonable periods of useful life for their depreciable property. . . . " but that the periods of estimated useful life used by taxpayers are subject to review by the Internal Revenue Service, and taxpayers should be prepared to substantiate the period so used.

Also in 1955 (IRB 1955-8, 53, 1955 CCH Standard Federal Tax Reporter, Para. 37,118A), Part 1 of the 1942 revision of Bulletin "F" was revoked. But Part 2, including that part which is of primary significance to this case—the tables of useful lives and depreciation rates—was not revoked.

gradual, extending over a period of years. *It is ordinarily called depreciation, and the period over which it extends is the normal useful life of the asset.*" (Emphasis added.)

Bulletin "F" contains estimated useful lives and rates of depreciation. The title page states that the useful lives shown therein ". . . are set forth solely as a guide or starting point from which correct rates may be determined in the light of the experience of the property under consideration and all other pertinent evidence." In Bulletin "F", the Treasury Department informs taxpayers (page 52) that the estimated useful life of automobiles which are "used by commercial enterprises other than public utility and construction" [8] is five years for passenger automobiles and three years for automobiles used by salesmen. Since plaintiff's automobiles were rented and leased for both purposes, the reasonableness of a four-year useful life is sustained by the Commissioner himself. And, we emphasize, Bulletin "F" makes it clear that although such averages "are not prescribed for use in any particular case", they are a starting point from which correct rates may be determined.

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[8] The special classification in Bulletin "F" (page 29) for automobiles used in the construction industry (light—two years, medium—three years, heavy--five years) is a significant variation from the standard three- and five-year lives for automobiles generally, by reason of the introduction to the table of useful lives in the construction industry, which clearly underlines the physical basis of the useful life concept by stating (page 28):

> "Ordinarily, the physical property used by contractors in construction has relatively short lives, due to hard usage and, often, general lack of upkeep during rush jobs."

Thus, if testimony to the contrary had been offered, the *prima facie* showing made in Bulletin "F" might perhaps have been overcome. But the only testimony in the record is wholly consistent with Bulletin "F", *i.e.,* that automobiles used in the car rental or car leasing business have a useful life of four years.

We do not believe it plausible that when the Commissioner listed in Bulletin "F" (page 52): "Trucks: . . . medium—6 years; Heavy—8 years", he meant that a medium truck would be *kept and used by a given taxpayer* for six years, and a heavy truck would be *kept and used by that taxpayer* for eight years. Did he not unquestionably mean that though it would be almost impossible to foretell when a taxpayer might decide, perhaps for reasons wholly unconnected with the condition of the truck, to sell it to a neighbor or trade it in on a new one, it was feasible to say that a medium truck, whether in one taxpayer's or a half dozen taxpayers' hands, has a *life* of approximately six years, whereas a heavy truck has a *life* of approximately eight years?

(We cannot refrain from asking why the Commissioner did not simplify his task by stating, in far more simple terms and in one page instead of a catalog of physical lives, that the useful life of a depreciable asset would be *its period of use by a particular taxpayer* if that indeed were his view.)

From the foregoing it would seem clear that if the situation were reversed and the taxpayer in this case were contending for any period other than one suggested by Bulle-

tin "F"—be it a two-year period or a six-year period—as the useful life of its automobiles, the Commissioner would be insisting that in the absence of some justification, such as testimony from the witness stand, or "informed opinion" (Bulletin "F", page 3), or the presentation of experts in the field—Bulletin "F" must govern. Would the Government not be arguing that the unsupported opinion of the taxpayer could not be permitted to *change* the useful life set forth as a guide in Bulletin "F"?

The taxpayer, however, showed affirmatively (R. 70) that the applicable useful life, in this case four years (the average of the three-year and five-year guides set forth by the Government in its Bulletin "F"), is the normal useful life for automobiles used in business.

The Government's position is made to look even more peculiar by reason of Treasury Decision 4422, XIII-1 CB 58, issued by the Commissioner of Internal Revenue under date of February 28, 1934 and still in effect. That decision specifically provided that "The burden of proof will rest upon taxpayer to sustain the deduction claimed [for depreciation]." If, as is apparent, Treasury Decision 4422 puts the burden squarely upon the taxpayer to justify its claimed period of useful life, and if, in the absence of proof, Bulletin "F" is to govern, how can the Government justify its opposition to the designation of a four-year useful life for automobiles when (a) the taxpayer justifies its claimed period by clear proof, unopposed by the Government by any other testimony *and* (b) Bulletin "F", designated by the Government as the "guide" of the taxpayer also supports the taxpayer?

With respect to Bulletin "F", the Ninth Circuit below correctly characterized its significance for the case at bar:

> "While we recognize that Bulletin 'F' does not have the force of law, we do believe that a fair construction of the pertinent provisions of such Bulletin, aided by the practice of the Commissioner, reasonably indicates that *the Commissioner did not consider as a factor in determining depreciation the expected or intended disposal plans of the taxpayer with respect to property used in his trade or business, nor did the Commissioner consider that the useful life of an asset was to be measured by the estimated holding period of such asset by the taxpayer.*" (264 F. 2d at 510; R. 113; emphasis added.)

Indeed, the Commissioner's new definition of "useful life" is inconsistent with the following rulings, which concerned the availability of capital gain treatment of profit from the sale of rented or leased motor vehicles:

In Rev. Rul. 108, 1953-1 CB 185, the Commissioner referred to the practice of selling automobiles after "leasing them for substantially less than their normal useful life". At the expiration of the lease period, the taxpayers involved sold the automobiles. The Commissioner thus was certainly not referring to a useful life which ends when the taxpayer sells the automobiles.

In Rev. Rul. 54-229, 1954-1 CB 124, again the Commissioner referred to a sale of automobiles after they had been leased for substantially less than their useful life. Again he was referring to a useful life in plaintiff's terms—in standard terms and terms consistent with Congressional enactment and intention.

If the Commissioner's present rationale of useful life and salvage value were correct, why did he not, in those rulings, state that the holding period of those automobiles was their useful life, that the selling price was their salvage value, and that, therefore, there was no capital gain? *Had the Treasury taken its present view of "useful life" and "salvage value" at the time these revenue rulings were under consideration, there would have been no need for the rulings, since the capital gain issue would have been effectively foreclosed.*

It is to be noted that this use by the Commissioner of the term "useful life" occurred—in both instances—in a context in which the question of depreciation on leased cars was expressly considered; and the Commissioner was equating useful life with the total functional life of the automobiles for business purposes despite the practice of the taxpayers involved of disposing of the automobiles well before the end of such functional life.

These rulings, and their interpretation of useful life by the agency charged with the responsibility of administering the Internal Revenue Code, are clearly of persuasive weight under the authorities (*Billings* v. *Truesdell*, 321 U.S. 542, 552-53 [1944]).

Furthermore, in its opinion below, the Ninth Circuit found clear indication in the foregoing official pronouncements of the Commissioner that the meaning of the term "useful life" was physical or inherent functional life of depreciable assets, saying:

"Our attention has been directed to certain pronouncements of the Commissioner dealing with the

general subject under review. In each of such pronouncements, it is evident that the Commissioner's concept of the term 'useful life' was not measured by the period in which the depreciable asset was useful in the taxpayer's business, but was measured rather by the economic or physical life of the depreciable asset." (264 F. 2d at 509; R. 110.)

In a number of briefs filed by the Commissioner in depreciation cases both under the 1939 Code and the 1954 Code, the Commissioner has also urged the definition of useful life which the taxpayer submits is correct.

A striking case is *Penn* v. *Commissioner of Internal Revenue,* 199 F. 2d 210 (8th Cir. 1952). There, the question was whether depreciation deductions on a building erected by a life tenant at her own expense were to be computed under Section 23(l) of the 1939 Code at a rate based upon the life expectancy of the life tenant, as the taxpayer claimed, or on the useful life of the building, as the Tax Court and the Court of Appeals held. At page 4 of the Commissioner's brief, the Commissioner stated:

> " . . . Taxpayer points to nothing which supports her novel contention that annual deductions for depreciation of property are to be computed by a life tenant on the basis of his own life expectancy, rather than on the basis of *the useful life of the property itself.*" (Emphasis added.)

And, most significantly, at pages 10-11 of the Commissioner's brief, the Commissioner forthrightly and correctly refutes the very argument which he makes in the present litigation:

> "The basic fallacy in taxpayer's argument lies in her assumption that 'depreciation' has reference to

the life of the owner of property, rather than to *the life of the property itself. . . .* Taxpayer's argument disregards not only the portion of Section 23(l) which deals specifically with property held by a life tenant, but the *general provision* that depreciation deductions are allowable 'for the exhaustion, wear and tear . . . of property'. *The wear and tear of 'property' has no relation to the life expectancy of its owner. On taxpayer's theory, every owner of a depreciable interest in property would be entitled to deduct annual depreciation at a rate based on the number of years he expects to live and enjoy the income from the property, instead of the number of years the property may be expected to produce income, a result repugnant to the fundamental concepts of depreciation.*" (Emphasis added.)

Both the court's holding and the Commissioner's position in *Penn* are antithetical to the Commissioner's new vie of useful life in this proceeding and in his 1956 regulations.

Even more recently, in the Commissioner's "Respondent's Brief in Answer," submitted in 1958 to the Tax Court in the *Hillard* case, 31 T.C. 961 (1959), Docket No. 61604, one of his "Points Relied Upon" (page 17) is:

"It is respondent's position that where, as here, petitioner . . . leases [cars] *for substantially less than their normal useful life . . .* the gain from the sale thereof is taxable as ordinary income." (Emphasis added.)

Further, in the Argument, at page 18, the Commissioner refers to the "leasing [of cars] for substantially less than their normally useful life. . . . "

Another example of the Government's recent assertions of this accepted interpretation of the term "useful life" appears in the Brief for Appellee filed in the Sixth Circuit in *Cohn* v. *United States,* 259 F. 2d 371 (6th Cir. 1958), cited by the Commissioner at page 16 of his opening brief in this Court. There, in a refund suit involving depreciation for the years 1942-1944, the Government said (Docket Nos. 13,360-62, brief, page 8): " . . . on the other hand, if the asset will be disposed of long before its useful life has expired. . . . " And later, at page 27, the Government argued that the taxpayers in that case " . . . realized that the goods were to be disposed of, long before the expiration of the assets' useful lives. . . . "

Again in the *Cohn* case, the transcript of proceedings (included in the Appendix of Appellants) reveals the following testimony of the technical adviser in the Appellate Division of the Internal Revenue Service assigned to the case:

> Page 245a: "In arriving at the useful life [of furniture, lockers and radio equipment] I considered first that all of this equipment was movable, that *unless it was of such specialized nature that it could not be used in any other business, the useful life of it should be determined by the life of the asset itself;* that a great deal of this equipment, in fact, substantially all of it, *could be used in other businesses;* for instance, the desks that they were using there *could be used anywhere.* I considered the fact that I had worked in offices for a number of years, and I know that the desks, even under the worst treatment, an oak desk would *last* more than ten years." (Emphasis added.)

This certainly is a forthright corroboration of the view that the useful life of an asset for depreciation purposes is its general business life—by whomever used. Further:

> Pages 246a-247a: " . . . these partners were engaged in a sort of a war business, and there was some reasonable expectation, or there should have been, that perhaps . . . their business would not last the duration of the war, and that perhaps . . . they could—would dispose of this equipment before the end of its useful life."

It appears impossible to square with that candid statement the Commissioner's arguments herein and the 1956 regulations' concept (Reg. Sec. 1.167[a]-1[b], Appendix A, *infra*, page 89) that useful life is "the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business. . . ."

The Commissioner's Fifth Circuit briefs in *Hillard*, 31 T.C. 961 (1959), now on appeal to the Fifth Circuit (Docket No. 17,915), are similarly revealing.

As to the four-year depreciable life used by the Commissioner on Hillard's cars, the Commissioner's Supplemental Brief for the Respondent (page 3) belatedly argues that the proper formula for depreciation "should have been" the expected period of usefulness in the particular taxpayer's business. (In his Respondent's Brief in Answer in the Tax Court, the Commissioner had made it a point [page 6] to show that "Petitioner sold his cars after a customary holding period of seven months to one year.")

As to the general definition of "useful life," the Commissioner's Brief for the Respondent (page 9) states, as the first point in his Argument:

> "After Reviewing All the Evidence Before It, the Tax Court Correctly Found that Rental Vehicles Leased by the Taxpayer *for One-Fourth of Their Useful Life and Then Sold* Constituted Property Held 'Primarily for Sale. . . .' " (Emphasis added.)

At pages 18 and 19 of the Brief for the Respondent, the Commissioner says:

> "The Tax Court recognized that when the taxpayer purchased the cars involved it was his intention to use them in the rent-a-car operation (R. 36) but, as the Tax Court also stated (*id.*), 'for a comparatively minor portion of their useful life and then to sell them.' * * * Those statements are amply justified by the evidence."

At page 4 of his Supplemental Brief for the Respondent, the Commissioner attempts this explanation:

> "Since no issue of depreciation was here present, the Tax Court's statement (R. 36) that the taxpayer intended to use the cars in the rent-a-car operation 'for a comparatively minor portion of their useful life' obviously had reference only to the physical economic life of the cars."

What does appear obvious is that the Commissioner himself has equated the terms "useful life" and "physical economic life."

Indeed, the Government is still taking the long-established view of useful life in other cases under the 1954 Code. In *Highland Hills Swimming Club, Inc.* v. *Wiseman, District Director, and United States of America*, 59-1

USTC Para. 9284 (D.C.W.D. Okla. 1958), Docket No. 7672, (*aff'd* 272 F. 2d 176 [10th Cir. 1959]), the Government presented the question (brief, page 2) as follows: "Whether the Commissioner of Internal Revenue correctly determined that the taxpayer must depreciate its swimming pool over its physical life rather than the term stated in the lease [100 months], under the provisions of Section 167 of the Internal Revenue Code of 1954." And at page 9 of the Government's brief, the following statement appears: "The swimming pool had a useful life of 20 years. It is *not realistic* that the taxpayer only *contemplated its use* for approximately two-fifths of its useful life." (Emphasis added.) Is "useful life" the period of *contemplated use* by a particular taxpayer, as the Commissioner herein and new Reg. Sec. 1.167(a)-1(b) say it is? The last sentence of the above quotation appears to constitute a flat denial by the Government that that is the case.

Are we not justified in suggesting that the Government is shaping basic depreciation principles on an *ad hoc* basis in each case? In *Herbert Shainberg, et al.*, 33 TC No. 28, decided by the Tax Court on November 10, 1959, the taxpayers, who operated a shopping center, had claimed 200% declining balance depreciation, under Section 167 of the 1954 Code. There apparently was agreement that, on any theory of useful life, the assets involved all had useful lives of three or more years and were therefore eligible for such depreciation. Hence, once past the three-year eligibility question, the Government attempted to stretch out the useful lives of the assets involved in order to produce lower depreciation rates than those claimed by the tax-

payers. We believe the Commissioner's brief to the Tax Court in *Shainberg* (Docket Nos. 71618-20), filed on June 18, 1959 and signed by Arch M. Cantrall, Chief Counsel, Internal Revenue Service, speaks for itself:

> "The *physical life* of the component parts of the buildings is a prime factor to be considered in determining the useful life of these assets. Presumably, unless other factors are present which would reduce the *physical life* of an asset, *there is no reason why the physical life and useful life would not be the same.*" (Page 54; emphasis added.)

Here is a clear admission by the Commissioner that the plaintiff's useful life is correct, for the "other factors"[9] which would reduce an asset's *physical* life certainly do not include the taxpayer's projected holding period.[9]

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[9] The particular *operating practice* of a taxpayer—as contrasted with his projected period of use—certainly may have important effects on the physical life of an asset. Thus the particular use may shorten the total period of economic usefulness materially—usually through abnormally heavy operation or undermaintenance. To the extent that such operating practice is proved (as opposed to merely proving the taxpayer's holding period), a taxpayer is permitted to adjust his depreciation rate accordingly. *Louis E. Whitham, et al.*, 10 TCM 250, 255 (1951). This well-established principle represents a faithful recognition of, and allowance for, the "variables" referred to by this Court in *Detroit Edison Company* v. *Commissioner of Internal Revenue*, 319 U.S. 98, 102 (1943).

Indeed, the Commissioner has advocated the principle in unmistakable terms in other places. In *W. N. Foster, et al.*, 2 TCM 595 (1943), the Commissioner—in the face of proof that an automobile was purchased in January, 1938 and sold in January, 1940—argued (Docket Nos. 110779, 110780, Commissioner's reply brief, pages 25-26) as follows: "In Bureau Bulletin 'F' the average useful life

Before the promulgation in 1956 of his regulations under Section 167 of the 1954 Code, the Commissioner's public pronouncements—Bulletin "F," revenue rulings and briefs submitted to the courts—have without exception defined the term "useful life" in a way consistent with the taxpayer's views as to the meaning of that term. Indeed, the taxpayer has shown that even after the promulgation of his 1956 regulations, the Commissioner has taken a position in briefs filed with the courts inconsistent with his contentions in this case.

With nothing in the applicable regulations, rulings or decisions to sustain the Commissioner's present claims as to the meanings of useful life and salvage value, it is understandable that he would like this case to be decided on the basis of his newly evolved concepts in the 1956 regulations (Appendix A, *infra*, pages 89-91). The Commissioner's attempt to read those regulations into the case at bar, after the fact, appears clearly in the table appearing at page 48, *infra*.

As the Ninth Circuit pointed out below:

> "There can be no dispute over the fact that the Tax Court applied to the facts of this case definitions of 'useful life' and 'salvage value' which appeared for the first time in Regulations T.D. 6182, promulgated under the 1954 Code. The Commissioner does not seriously argue otherwise." (264 F. 2d at 506; R. 106.)

(Footnote 9 continued)
of a passenger automobile used in business (other than be [*sic*] salesmen) is 5 years. Petitioners have not proved that the automobile was devoted to such *extraordinary uses* as to justify a higher rate of depreciation than that determined by respondent." (Emphasis added.)

From Commissioner's brief in the Ninth Circuit.	**From the 1956 regulations (not applicable to the taxable years 1950 and 1951).**	**From the applicable regulations—111.**
Page 7: " . . . [T]he Commissioner contends that, for the purpose of computing a reasonable depreciation allowance pursuant to Section 23(1), *the estimated useful life over which an asset is to be depreciated by a taxpayer is not necessarily the useful life inherent in the asset, and in the present case is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business*." (Emphasis added.) [This language is repeated in substantially identical manner at page 18 of the Commissioner's brief.]	Reg. Sec. 1.167(a)-1(b) [in part]: "For the purpose of section 167 *the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income*." (Emphasis added.)	[No definition of useful life is given in the applicable regulations.]
PP. 7-8: "Similarly, it is submitted that *salvage value*, as that term is used in the Treasury Regulations interpreting Section 23(1), *means the amount (determined at the time of acquisition) which it is reasonable to estimate will be realizable upon the sale or other disposal of the asset when it is no longer useful in a taxpayer's business and is retired from service*." (Emphasis added.) [This language is repeated in substantially identical manner at pages 18-19 of the Commissioner's brief.]	Reg. Sec. 1.167(a)-1(c) [in part]: "*Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer.*"	[No definition of salvage value is given in the applicable regulations.]

4. *Expert Testimony.*

At the trial, the taxpayer called two expert witnesses, certified public accountants, who are members of two of the country's outstanding accounting firms. In both cases, their testimony was based on many years of cumulative experience in public accounting (R. 83-84, 88-89).[10]

Drawing on this experience in applying the depreciation provisions of the federal income tax statutes and regulations, Paul F. Johnson, of Ernst & Ernst, testified that the term "useful life," as applied in the setting of depreciation rates, means the economic or physical life of an asset; that in his experience in dealing with representatives of the Internal Revenue Service, that term was used in its "accepted accounting meaning" of economic or physical life; that the term "salvage value" meant the junk or scrap

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[10] With respect to the testimony of these accountants, the Commissioner says (Brief for the Petitioner, page 30):

> "Commenting on similar expert testimony which had been offered in the *Hertz* case, the Third Circuit pointedly observed (268 F. 2d at 608-609) that the standard work on tax accounting, edited by four partners in the accounting firm of Lybrand, Ross Bros. & Montgomery, is directly to the contrary. *Montgomery's Federal Taxes* (37th ed. (1958)), c. 6, p. 4."

We note first that the Third Circuit did not, either at 268 F. 2d 608-609 or elsewhere in its opinion in *Hertz*, call the cited text "the standard work on tax accounting."

Further, not only were the authors of the text not produced for cross-examination at the trial, but an examination of the cited pages makes it quite apparent that these authors were simply reporting the opinions of lower courts in the depreciation litigation *now before this Court*, and their remarks may in no sense be taken as contradictory to the testimony of the accountants.

value of an asset—a value which is normally "negligible in the overall evaluation"; and that, if the Internal Revenue Service is now contending that the useful life of an automobile for depreciation purposes during 1950 and 1951 is the actual period during which the taxpayer held the automobile, and that salvage value is "average sales proceeds", this is a change from the practice of the Internal Revenue Service during the period 1950 and 1951 and years prior thereto (R. 84-86).

On cross-examination, Mr. Johnson further explained that the physical or economic life of an asset is the period for which it will be useful to *someone*; that an asset may be put to more strenuous use in the hands of one taxpayer than in the hands of another, and that such use would make the physical life of that asset shorter than it would be in someone else's business; but that the useful life of an asset is the period for which it will be useful to someone (R. 87).

Raymond A. Hoffman, a partner in the firm of Price, Waterhouse & Co., testified that in his experience in approximately 20 years in business accounting, devoted primarily to federal income tax work, in dealing with representatives of the Internal Revenue Service no other meaning has been attached to the term "useful life" than "the physical life or economic life for the purpose for which a particular asset was intended by the manufacturer"; that the term "salvage value" is generally looked upon as synonymous with junk value at the end of the useful life of the asset; and that the contentions of the Internal Revenue Service in this case that useful life for automobiles in 1950 and 1951 was the actual period during which the

taxpayer held the automobiles, and that the salvage value was the average proceeds from the sale of the automobiles, represent a change of practice by the Service (R. 89-90).

It is significant that the Commissioner failed to offer any evidence to contradict the testimony of the taxpayer's experts. Furthermore, the record shows that their testimony remained unimpeached after the Commissioner's cross-examination (R. 86-88, 90-92).

It is well established that testimony of expert witnesses as to the correctness and prevalence of the administrative interpretation of a phrase involving accounting concepts, such as "useful life" and "salvage value", is particularly pertinent. The principle was recognized by this Court in *Willcuts* v. *Milton Dairy Company*, 275 U.S. 215 (1927), where the ordinary business meaning ascribed to a corporate accounting phrase was held to provide an authoritative interpretation of that phrase as used in the Revenue Act of 1918.

This Court recently applied the same rule in *The Colony, Inc.* v. *Commissioner of Internal Revenue*, 357 U.S. 28, 32 (1958):

> ". . . statutory words are presumed to be used in their ordinary and usual sense, and with the meaning commonly attributable to them."

The only record evidence before this Court on the meaning of the term "useful life" is the experience of the taxpayer's witnesses, in dealing with Internal Revenue agents in the field under the 1939 Code, that useful life meant general business life, not an individual taxpayer's holding period (R. 85, 89).

The Ninth Circuit in its opinion below gave weight to the testimony given by the two certified public accountants at the trial in the Tax Court, saying:

> "The long-continued and consistent practice and position of the Commissioner in measuring useful life by the physical or economic life of the depreciable asset were reflected in testimony before the Tax Court." (264 F. 2d at 511; R. 114.)

The position taken by the Commissioner in the decided cases (heretofore discussed) is contrary to his present position. The Commissioner's position in those cases was certainly known both to the accountants who testified and to the agents working in the field. If the Commissioner's counsel had been able to show that this was not the case, he could readily have called supporting witnesses from the government agency in possession of full knowledge of the facts—the Internal Revenue Service.

Thus, the law on useful life, as it stood during the taxable years in issue, and still stands, consisted of the following:

(i) A basic depreciation statute re-enacted many times, substantially unchanged, in successive revenue acts over a period of more than 35 years, in the light of, and without any significant change in

(ii) the Commissioner's basic depreciation regulations, which had been long continued in virtually identical form since 1918, and which

(iii) were consistently interpreted by the courts, and by the Commissioner himself, as applying and defining useful life as the life of an asset for general business purposes and not the period during which it happens to be held by a particular taxpayer.

That interpretation of useful life had the force of law by virtue of repeated re-enactment by Congress of the underlying legislation, under the principle of *Helvering* v. *Winmill,* 305 U.S. 79, 83 (1938):

> "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law."

Accord: *Commissioner of Internal Revenue* v. *Flowers,* 326 U.S. 465, 469 (1946); *Boehm* v. *Commissioner of Internal Revenue,* 326 U.S. 287, 291-92 (1945); *Lykes* v. *United States,* 343 U.S. 118, 127 (1952); *Cammarano* v. *United States,* 358 U.S. 498, 510-11 (1959).[11]

Prior to the promulgation in June, 1956, of regulations under Section 167 of the 1954 Code, the term "useful life" was consistently interpreted by the courts, the Commissioner and accountants to mean the physical life of the asset. Indeed, up to that time, disputes between the Commissioners and taxpayers invariably arose because the Commissioner was attempting to impose a longer period of depreciability (one measured by the useful life—the physical life—of the assets) than the taxpayer was willing to employ.

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[11] In *Cammarano* (Nos. 29 and 50, October Term, 1958), it was the Government which argued (Brief for Respondent, page 11):

> "The regulation in question, having been in existence for some forty years and during a period in which the underlying statutory provision has been repeatedly reenacted, has acquired the force of law."

In the entire course of this litigation, the Commissioner (contrary to his assertion at pages 8-9 of his opening brief) has not offered a single citation of any case or ruling decided or published before the enactment of Section 167 of the 1954 Code in which he even contended (much less established) that useful life meant a taxpayer's holding period. It is significant that no such citation could be offered. One would think that in the course of decades of administering a statute which required thousands of taxpayers annually to determine for depreciation purposes the useful lives of their assets, the Commissioner would have at some point taken the position now being urged by him if, as he now contends, that has been the position right along. "Against the Treasury's prior long-standing and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand."[12]

II.

THE TERM "SALVAGE VALUE," FOR DEPRECIATION PURPOSES, MEANS THE RESIDUAL, JUNK OR SCRAP VALUE OF PROPERTY REMAINING AT THE END OF ITS "USEFUL LIFE," AS DEFINED ABOVE, NOT THE ESTIMATED PROCEEDS WHICH MAY BE REALIZED FROM THE DISPOSITION OF THE PROPERTY WHEN A TAXPAYER DISPENSES WITH IT BEFORE THE END OF ITS USEFUL LIFE.

The salvage value of an asset under any definition of useful life is a residual value—the asset's value upon the completion of the depreciation process at the end of its useful life. Thus, the present controversy over the mean-

[12] *United States* v. *Leslie Salt Co.*, 350 U.S. 383, 396 (1956).

ing of useful life carries with it a corollary controversy over the meaning of salvage value, which is the reciprocal of useful life.

The meaning of "salvage value", for depreciation purposes, emerges inevitably from the preceding discussion of "useful life". It is the residual, junk or scrap value of property left at the end of its physical "useful life." "Salvage value" is not the speculative amount which may be realized from the disposition of the property before the end of its useful life.

In accordance with the Commissioner's Regulations 111, Sec. 29.23(l)-1, depreciation over the useful life of the asset plus salvage value equals cost. Thus, salvage value is the reciprocal of useful life—the value remaining at the expiration of the inherent physical life of property, which, as we have demonstrated above, is the proper definition of "useful life". It is that part of a property's value which can never be destroyed by depreciation, that is, by exhaustion, wear and tear. The testimony of qualified expert witnesses shows that the business community regards salvage value as having such a meaning (R. 85, 87, 89, 90).

The Commissioner, having once departed (in his 1956 regulations and in recent litigation) from the established meaning of useful life, has naturally found it necessary to revise also the accepted meaning of salvage value.

But if useful life, as currently urged by the Commissioner, means something less than the period of substantially full exhaustion of the usefulness of the asset for general

purposes, the undepreciated balance after a particular *period of use* may be relatively substantial. This, in turn, leads to the introduction of a new factor—sales or market value of an asset which is not substantially exhausted or used up.[13]

As shown below, the factor of "market value salvage" has been consistently negated by the courts and by the Commissioner himself as an element in the determination of depreciation rates or the amount of depreciation which may be taken. The aggregate of depreciation and true salvage value—nominal or scrap or junk value—in the established method for determining depreciation cannot exceed the taxpayer's cost or other basis. Fluctuations in the market value of depreciated assets—as contrasted

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[13] If this new factor and the Commissioner's new opinion of "useful life" were accepted, they would undoubtedly produce interesting income tax litigation, in quantity, in the City of New York and other metropolitan centers where construction of office and other buildings is proceeding at a rapid pace. Suppose a building owner estimates that he will hold his building for five years and will then sell it. He estimates his sales proceeds as $X. Will the Commissioner find fault—or be able to find fault—with a five-year projection of the amount which the building may bring at a time when booming real estate construction either may be continuing or may have wholly stopped? Is the Commissioner likely to allow a five-year useful life on a brand-new office building? If the owner estimates that he will get more than his original cost upon sale of the building after five years, is he entitled to no depreciation at all? If the owner believes that he will hold the building indefinitely, is the building's useful life equal to his life expectancy (contrary to *Penn* v. *Commissioner of Internal Revenue*, 199 F. 2d 210 [8th Cir. 1952])?

with the exhaustion of their service capacity[14]—are reflected in the taxpayer's income, in the year of disposition, under Section 117(j) of the 1939 Code, or Section 1231 of the 1954 Code, in the sense that such fluctuations may affect the amount of his taxable gain or loss upon disposition of the assets.

The example at page 28, footnote 16 of the Commissioner's opening brief is plainly fallacious and irrelevant. It seeks to make a point by constructing a "recovery" through sales (at what the market happens to bring) and then injecting this "recovery" into a statutory standard which grants a deduction for "exhaustion, wear and tear," *not* reduction in market value. It simply confuses realization through sales (at what the market happens to bring) with "recovery" through depreciation deductions.

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[14] "It is true that a machine which has been installed and used for a few weeks is already second-hand and could be sold for perhaps not more than half its cost, although it may still have a service life of 10 years. But the machine is not being held for sale; it is being held for use, and if only 3 months have expired of its total service life of 10 years, then only 1-40 of its value to its owners has expired, and 39-40 of its value to them remains. The fact that its sale value might be less has nothing to do with the case. In other words, depreciation measures the exhaustion of service capacity in the assets; it does not measure the fluctuations of market prices of those or similar assets. It is well understood that if any question of the sale of the properties should arise, their current market value would become very important; but information on that subject would naturally be sought for outside the books of account." Thomas Henry Sanders (Professor of Accounting, Graduate School of Business Administration, Harvard University), *Industrial Accounting, Control of Industry Through Costs*, 147 (New York: McGraw-Hill Book Company, Inc., 1929).

This obvious error results from a confusion in concepts. But even using the Commissioner's own example, for the sake of argument, the dollars and cents result which he obtains (on the basis of the three variables which he chooses to use—purchase price, sale price and the depreciation deduction) should be as follows:

Cost		$1650.00
Depreciation (fifteen months)	515.00	
Combined normal tax and surtax (taxpayer's effective rate for 1950)	34%	
Tax saving through depreciation		175.10
Unrecovered investment		1,474.90
Sales price	1,380.00	
Tax on gain (17%, or ½ of 34%, of $1,380.00 minus $1,135.00 [depreciated cost])	41.65	
Net sales proceeds		1,338.35
*Un*recovered amount		136.55

(During the period under review, used car prices went up abnormally because of the Korean War and anticipation of shortages [R. 71]. Thus, a similar analysis of the record figures for 1952, 1953 and 1954, when prices became more normal, shows even greater unrecovered amounts for those years.)

The "total recovery" of $2,078.75 and the "gain" of $428.75 in the Commissioner's example are non-existent. Among other misleading procedures, the Commissioner, in arriving at $2,078.75, has used the assumed sales price—$1,380.00—once in its entirety and then has re-used $183.75 of the same amount in arriving at the "total recovery."

Another crucial error in the Commissioner's example is that any so-called excess "recovery" would occur, *if the market were as relatively favorable as it happened to be during 1950 and 1951,* irrespective of the tax rate applied—whether the capital gain rate of Section 117(j), which is the obvious target of the Commissioner's new theories, or some other rate. If gains on the sale of business assets were taxed at the taxpayer's effective rate for 1950—34%—there would still be, using the Commissioner's computation, a "gain" of $406.70, *despite the fact that every penny of depreciation claimed and allowed at the 34% rate would be picked up as taxable ordinary income, upon sale, at the same 34% rate.* (Even at the corporate rate of 42% in effect for the calendar year 1950, the Commissioner's assumptions would produce a "gain" of $387.10.)

Thus, if we are to follow the Commissioner's computation, the only way in which such so-called excess "recovery" could be avoided would be by imposing a 100% tax on the "profits" realized on the sale of business property.

But the Commissioner has himself recognized in *Hertz,* No. 283, this Term, that ". . . the sale price might supply the undepreciated cost; this, however, would not be a recovery through depreciation, but through relatively more profitable sales." (Docket No. 12,799, Third Circuit Brief for the Appellant, page 25, footnote 6).

Briefly, what the Commissioner is trying to do is to trim the depreciation deduction at both ends: greatly to reduce the actual depreciable life of an automobile, and greatly to reduce the amount which can be depreciated by calling

the resale value of the automobiles their salvage value. His proposed innovations have no basis under the cases, in his own practice, in the practice and understanding of accountants or in his own bulletins and regulations.

1. *The cases*

The claim that salvage value is measured by, or has any relation to, sales proceeds of an asset disposed of long before the end of its usefulness was rejected many years ago because it was contrary to logic and authority. For example, in *Reginald Denny*, 33 B.T.A. 738 (1935), the Board of Tax Appeals, in determining depreciation on an airplane, stated:

> "From the [taxpayer's] testimony, we gather that he regarded shrinkage of market value as synonymous with loss of useful value. *The two are rarely, if ever, the same.*" (33 B.T.A. at 743; emphasis added.) [15]

In *Louis Titus*, 2 B.T.A. 754 (1925), Acq. V-1 CB 5, the taxpayer argued that because he had to buy second-hand office equipment in 1917 at inflated prices, and disposed of it at a considerable loss in 1920, his claimed 20%-a-year depreciation rate was not excessive. The Commissioner and the Board of Tax Appeals disagreed (2 B.T.A. at 758):

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[15] This case is also of interest on the issue of the meaning of useful life. Denny bought his airplane "in 1924" and disposed of it "in the early part of 1926" (33 B.T.A. at 739, 740). Although his holding period was thus about two years, the Board held that a 20% rate (five-year life) would be a reasonable allowance for depreciation, and his claimed 40% rate (two-and-a-half-year life) was disallowed.

"In determining the annual depreciation to be allowed, consideration can not be given to the fluctuations in cost or value of the assets which may take place from year to year owing to market conditions. The fact that second-hand furniture sold at a high figure in 1917 and at a low figure in 1920 can not, therefore, be taken into account in determining the rate of depreciation which should be allowed the tax payer."

(Moreover, despite the fact that the taxpayer owned the equipment only three years, not only did the Commissioner and the Board reject the taxpayer's claimed 20% rate, but they held that a 10% rate—10-year useful life—was correct. That action clearly contravenes the Commissioner's current opinion as to the meaning of useful life.)

A case cited by the Commissioner in the Ninth Circuit proceeding below (Brief for the Respondent, page 46) directly supports the taxpayer's position on salvage value. Commenting on *W. Horace Williams Company, Inc.*, 56-2 U.S.T.C. Para. 9839 (D.C.E.D. La., 1956), affirmed without discussion of this point, 245 F. 2d 559 (5th Cir. 1957), the Commissioner's brief states:

"In that case the salvage value of a particular asset [the barge *Cap*, a converted LST], in 1948 and 1949, was $50,000. In 1950, the tax year in question, the salvage value fluctuated from zero to $30,000. The court found that an estimated value of $30,000 was fair and reasonable and the depreciation allowance for 1950 was adjusted accordingly." (Pages 46-47, footnote 27, Commissioner's brief.)

The Commissioner's truncated version of the court's holding in the *Williams Company* case could well produce a

mistaken impression. Actually, the case fully supports the taxpayer. Finding of Fact No. 29 in that case reads, *in full*:

> "The salvage value of the Barge *Cap* at various times during 1950 ranged from zero to $30,000, *fluctuating with the price of and demand for scrap.*" (Emphasis added.)

In *Pilot Freight Carriers, Inc.*, 15 TCM 1027 (1956), as in the case at bar, the Commissioner argued that the useful lives claimed by the taxpayer for tractors and trailers were erroneously computed because, upon sale by the taxpayer, the latter received "amounts largely in excess of the depreciated cost thereof" (15 TCM at 1032). The court rejected that argument, citing, from *Wier Long Leaf Lumber Co.*, 9 T.C. 990 (1947), Acq. 1948-1 CB 3 (reversed on other issues, 173 F. 2d 549 [C.A. 5th, 1949]), this principle:

> "The sole fact therefore in any specific situation that a given price is received for articles not fully depreciated throws no light on the effect upon the depreciation allowance." (9 T.C. at 999.)

One illogical offshoot of the Commissioner's new views appears in *Cohn* v. *United States*, 259 F. 2d 371 (6th Cir. 1958), which is included in a list of citations appearing at page 16 of his Brief for the Petitioner herein. According to *Cohn*, if a depreciable asset is sold during a taxable year for more than its depreciated basis as of the beginning of that year, no depreciation is allowable on the asset for that year. Understandably, the Commissioner is now treading lightly on *Cohn*, which, he urged on oral argu-

ment below, supported his position; for *Cohn* focuses sharply, we believe, on a key weakness in the Commissioner's new theories.

Let us suppose that Taxpayer X buys two new items, identical punch presses, for the same price, on the same day—January 1, 1950. (The rate of depreciation is immaterial.) After the presses have been in continuous use for the same purpose and at the same rate of operation in X's business, X sells one of the presses on December 1, 1953 for an amount *less* than its depreciated cost on January 1, 1953. On December 15, 1953 he sells the other. For any one or more of a host of reasons—a strike, a war scare, better prospects in industries using that kind of press, the sudden need of a buyer with unexpected orders, or the like—X gets a price for Press No. 2 *more* than its depreciated cost on January 1, 1953.

Cohn's viewpoint is that X may have *full* depreciation on Press No. 1 for eleven months of 1953, but *zero* depreciation on Press No. 2 for eleven months and 15 days of 1953, despite the fact that the "exhaustion, wear and tear" of the two machines—*i.e.*, that for which the statute offers a deduction—has, of course, been virtually identical.

There could hardly be a better demonstration of the Commissioner's new market value theory of depreciation and of that theory's divergence from the statutory standard.

Reversing his stand of long duration, the Commissioner now chooses to ignore the point that federal income tax depreciation is based on the annual loss of value resulting

from exhaustion, wear and tear, which are physical facts. Under the Commissioner's new theories, the starting point in determining the amount of depreciation allowable is the amount realized by the taxpayer on disposition of his automobiles. But it is clear that such amounts were not determined by the physical facts of wear and tear of his automobiles. In this case, those amounts were basically determined by reference to the automobile dealers' handbook of values (N.A.D.A. book), which is revised every 30 days (R. 58, 60). The amounts realized by the taxpayer were merely whatever happened to be the market values at a particular period of time in the physical life of the cars.

2. *The Commissioner's pronouncements.*

In quoting the applicable depreciation regulations at Appendix A, page 37, of his Brief for the Petitioner, the Commissioner has himself pointed up the fact that market fluctuations have nothing to do with depreciation:

> "For convenience such an allowance [*i.e.*, the statutory depreciation allowance] will usually be referred to as depreciation, *excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence.*" (Regulations 111, Sec. 29.23[1]-1; emphasis added.)[16]

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[16] It is significant that this express limitation did not appear in the preliminary draft of the regulations under the Revenue Act of 1918 (see page 48 of House Document No. 1826, 65th Cong., 3d Sess., referred to in the Commissioner's brief, page 20, footnote 8), but was deemed important enough to add to the final form of the regulations.

The cases have made it clear that of course the limitation also applies in the converse situation—where there is an actual appreci-

The reason for this express exclusion from the depreciation concept of the nebulous factor of future sales proceeds has been well stated by the Commissioner himself. In its opening brief to the Third Circuit in *Hertz*, No. 283, this Term, the Government frankly admitted (pages 28-29, footnote 9):

> "It is true . . . that this recovery might be improved somewhat by the fact that a resale of the asset at an earlier date would result in a resale price higher than estimated salvage value. The amount of such recovery on the resale is *purely conjectural, however, based as it necessarily is upon the saleability of the asset, the conditions of the particular business and business conditions in general. In any event, a recovery through higher resale is not a recovery through depreciation.* . . ." (Emphasis added.)

(Footnote 16 Continued)
ation in market value. For example, in *Max Eichenberg*, 16 B.T.A. 1368 (1929), the taxpayer owned a depreciable building for seven years, but claimed a depreciation deduction only during the last year. He argued that since he sold the building for more than his original cost, no depreciation was sustained (and that his basis upon sale was therefore virtually unimpaired). This argument was rejected (16 B.T.A. at 1370):

> "[Taxpayer contends] that any physical depreciation of the brick business house was more than compensated by appreciation resulting from increase in the cost of building materials during the term of his ownership. We have heretofore held that for the purpose of computing profit from the sale of depreciable property sustained depreciation may not be offset by appreciation in the market value of the property involved. This issue is controlled by our decisions in *Even Realty Co.*, 1 B.T.A. 355, and *Seton Falls Realty Co.*, 6 B.T.A. 883, which have been fully sustained by the Supreme Court in *United States* v. *Ludey*, 274 U.S. 295."

We note two things: First, the Government admits that the direction of Reg. Sec. 1.167(a)-1(c) of the 1956 regulations (Appendix A, *infra,* pages 90-91) that salvage value be estimated as the amount realizable upon sale is a direction to guess at a "purely conjectural" amount. Moreover, if recovery through resale is not recovery through depreciation, what can sales proceeds have to do with the basic theory of depreciation?

Although obviously not of controlling importance, the fact is that, so far as we have been able to ascertain, none of the individual or corporation income tax return forms over the years (currently Forms 1040 and 1120, respectively) has ever specified salvage value as an item to be set forth in the schedule requiring an explanation of the deduction for depreciation. This is true despite the fact that the depreciation schedule has uniformly required submission of detailed data on date of acquisition of the property, cost, depreciation allowed or allowable in prior years, life and other items.

In at least one place in the Treasury's tax regulations, the Commissioner has expressly equated "salvage" with scrap or junk. From 1940 to 1958 (thus including the taxable years under review), the federal excise tax regulations contained the following definition:

> "The term 'manufacturer' includes a person who produces a taxable article from scrap, salvage, or junk material, as well as from new or raw material, (1) by processing . . . [etc.] . . . ."

(Promulgated January 8, 1940 in Regulations 46, 5 F.R. No. 7, January 11, 1940, 142, 143, 26 C.F.R. [Cum. Supp. 1944] Part 316, §316.4.)

This usage accords with the following view:

> "Salvage is not regarded as a proper description of the proceeds received in the case of *sales*, fire losses, or other 'abnormal retirements'. . . ." (Emphasis added.)

(American Bar Association, Section of Taxation, 1959, Program and Committee Reports to be presented at the Twentieth Annual Meeting of the Section to be held August 20-25, 1959, Miami, Florida, Report of the Committee on Depreciation and Amortization, page 38.)

Regulations under the 1939 Code for many years before 1954 described depreciation as "excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear or obsolescence." (Reg. 111, Sec. 29.23[l]-1.) The Commissioner's new salvage value theory in this case is therefore wholly inconsistent with his own pronouncements. He has asked the Court herein to equate market value at the time of disposition of taxpayer's cars with salvage. Such a request cannot be squared with the regulations governing this case.

3. *Congressional intent.*

Congress itself has recognized that the taxpayer's sales proceeds may be substantially in excess of salvage value. That sales proceeds are not equivalent to salvage value appears clearly in the legislative history of Section 117(a) of the Revenue Act of 1938 (52 Stat. 447, 500), which excluded depreciable business assets from the category of capital assets so as to permit taxpayers to obtain ordinary (instead of capital) losses on sales of such assets. At pages 34-35 of House Report No. 1860, 75th Cong., 3rd

Sess., accompanying the Revenue Bill of 1938, the House Ways and Means Committee stated (1939-1 CB [Part 2] 752-53):

"Suppose that X, a manufacturer, purchased in 1932 a large machine, at a cost of $50,000. At the time of acquisition and installation in his plant, the machine had an estimated useful life of 10 years. X was therefore allowed an annual deduction from gross income for depreciation on the straight-line method of one-tenth of the cost, or $5,000, with respect to this machine. Assume that in 1938, when the machine has been in use for six years, a new and improved type of machine is introduced, the installation of which would materially reduce X's costs of production. X has, however, recovered only 60 per cent of the cost of the old machine through the annual deduction for depreciation. Let it be further assumed that X could sell the old machine to Y, another manufacturer, for $7,500, which is only 15 per cent of its cost to X, *but is materially in excess of its junk or salvage value.* If such a sale were consummated, X would sustain an actual loss of $12,500 on this machine." (Emphasis added.)

If the proceeds of sale are higher than the asset's depreciated cost, they are subject to a capital gains tax. If they are lower than the asset's depreciated cost, the taxpayer may take the loss as an offset against ordinary income. If the availability to the taxpayer of this result displeases the Commissioner of Internal Revenue, the source of his displeasure is Congress, not the taxpayer. The latter merely uses the doors intentionally left open for him by a Congress intent upon giving him this benefit for the sake of the economy as a whole.

The sum of the deductions for depreciation plus salvage value equals recovery by depreciation. What the taxpayer happens to receive upon the *sale* of the asset is not recovery by depreciation.

Upon analysis, it appears that the Commissioner's new theory of depreciation embodies the philosophy of providing an allowance for the decline in the market value of an asset during the period in which it happens to be used by a particular taxpayer. Under this theory, the cost of the asset, less the amount for which he anticipates selling it, constitutes the taxpayer's basis for depreciation. This basis is to be written off during the period in which he holds the asset. In brief, the sum to be depreciated, under this new theory, is essentially the difference between two market value figures—the first derived when the taxpayer purchases the asset and the second when he sells it.

But depreciation is an accounting concept and not a market concept. It measures, and is intended by Congress to measure, value decline only in terms of the erosion of usefulness by exhaustion, wear and tear. For example, depreciation certainly goes on and is allowed even in periods of extraordinary demand when used assets appreciate in market value. The Commissioner's holding-period-sales-proceeds approach in the case at bar and in *Hertz*, No. 283, this Term, may provide an arithmetical measure of something, but it is not a measure of the exhaustion, wear and tear of the asset.

In the case at bar, as in *Hertz*, the Commissioner attempts to sustain his position that without his new defi-

nition of salvage value a taxpayer might recover, by deductions for depreciation, almost the full cost of an asset and then sell the asset in a favorable market at a price which brings him more than salvage value.

To this a series of answers presents itself:

(1) The taxpayer must pay a tax out of any profit thus realized.

(2) He need pay only a capital gains tax because Congress chose to apply only the capital gains tax in order to encourage the earlier sale of depreciable assets, and the purchase of new assets, with attendant advantages for the economy.

(3) Such profit—if and when obtainable—results from *something which has no connection with depreciation: the state of the market.* Should the taxpayer be required to forecast the state of the market for goods which he may sell after a period of years, the length of which period he cannot prognosticate because of admittedly unpredictable factors (R. 65, 66-67, 69-71)?

True, depreciation deductions over the full useful life of an asset plus salvage are not permitted to total more than original cost. And just as it is substantially easier to estimate the full useful *life* of an asset than it is to estimate the length of time a given taxpayer will *use* that asset before selling it, something of the same considerations make it much easier to estimate *salvage*—scrap, junk or residual physical—value than to estimate what the asset will bring, after an unknown period of use, when it is sold by reason of unpredictable factors. The state of the

second-hand market in that asset may itself dictate the date of sale. A new invention may dictate the date of sale. Ordinary wear and tear—real depreciation—may dictate the date of sale. Or unexpected competition, or unexpected weather, or an unexpected strike, or a variety of other factors may dictate the date of sale.

III.

THE PROPER FORUM FOR THE COMMISSIONER'S ARGUMENTS IS CONGRESS, NOT THE COURTS, FOR THE COMMISSIONER'S REDEFINITIONS OF USEFUL LIFE AND SALVAGE VALUE ARE INTENDED TO ABROGATE, BY ADMINISTRATIVE ACTION, SECTION 117(j) OF THE 1939 CODE AND SECTION 1231 OF THE 1954 CODE.

As indicated at the beginning of our argument, it seems clear that what the Commissioner is trying to do in this case is to assert a new definition of "useful life" which, in conjunction with his new definition of "salvage value," would mean that, generally speaking, taxpayers would not be able to avail themselves of capital gains upon the sale of business assets under Section 117(j) of the 1939 Code (or its successor, Section 1231 of the 1954 Code).

As we have pointed out above (page 11), the Commissioner, in his deficiency notice (R. 12), originally contended that any gain realized by the taxpayer from the sale of his automobiles was includible in the taxpayer's returns not as capital gain, as reported, but as ordinary income—on the theory that the taxpayer was a dealer in automobiles. In his brief before the Tax Court, the Commissioner abandoned that contention and conceded the taxpayer's right, under Section 117(j) of the 1939 Code, to treat sales of his

automobiles as sales of property used in his trade or business, not held primarily for sale to customers in the ordinary course.

But that concession is meaningless if this Court accepts the Commissioner's new definitions of useful life and salvage value, since the Commissioner's argument in this case is designed to achieve administrative repeal of Section 117(j) and the 1954 Code provision, Section 1231. Indeed, the Commissioner's counsel admitted as much at the hearing before the Tax Court when he stated:

> ". . . our position is somewhat in the alternative because we have adjusted the useful life and we have adjusted the depreciation and in taking that action we have cut down the amount of gain or profit considerably." (R. 40.)

The Treasury has tried several times to prevent the realization of capital gains on the sale of depreciable business property under Sections 117(j) and 1231 in other ways—without success. In the light of the history of those provisions, it is astonishing to see the Commissioner continuing his efforts arbitrarily to vitiate them.

The Treasury's first attempt occurred during the extensive Revenue Revision hearings held by Congress in 1947 and 1948, when the Business Tax Section of the Division of Tax Research of the Treasury Department submitted a report on accelerated depreciation to the Ways and Means Committee of the House of Representatives ("Revenue Revisions, 1947-1948", hearings of December 2-12, 1947, Part 5, page 3756), in which the Treas-

ury Department attempted to reduce the effect of the capital gains section in the 1939 Code (Section 117 [j]), stating:

> "[A] danger is that accelerated depreciation allowances might be used to convert ordinary income into capital gains, since a businessman might sell a fully depreciated asset that still had a substantial value, paying a tax on the capital gain and avoiding the taxes on its income that were deferred during the period of accelerated depreciation. This type of avoidance could be overcome by requiring that if the taxpayer elects to use accelerated depreciation, gain to the extent of the excess of accelerated over normal depreciation must be treated as ordinary income."

This initial straightforward attempt by the Treasury Department to change the design of the statute authorizing capital gain treatment for profits realized from the sale of assets subject to accelerated depreciation failed because Congress was adhering to the above-described policy of encouraging the sale of capital equipment and thus encouraging the purchase of new capital equipment.

In its second attempt, shortly thereafter, the Treasury Department took a different approach in its attack on Section 117(j). It recommended to Congress in 1950—one of the taxable years here under review—that losses on the sale of depreciable business property be treated as capital rather than ordinary losses. On February 3, 1950, Secretary of the Treasury Snyder told the House Ways and Means Committee:[17]

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[17] Hearings before the Committee on Ways and Means, House of Representatives, 81st Cong., 2nd Sess., "Revenue Revisions of 1950," Volume 1, page 20.

> "Another important loophole provides a 'one-way street' for taxpayers selling property which they have used in their trade or business. At the present time, such taxpayers are allowed capital-gains treatment when the sales result in a net gain, while net losses from such transactions are allowed in full as offsets against ordinary income."

Secretary Snyder referred, at the same page, to Exhibit 4 to his statement—a list of "Miscellaneous Tax Loopholes" prepared by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation. This exhibit stated, in part:[18]

> "The justification which the section [117(j) of the 1939 Code] might have had at the time of its enactment is believed to have disappeared with the termination of the war."

But Congress refused in 1950—as it refused in 1954 and still refuses—to eliminate the so-called one-way street in the taxation of gains on the sale of business property.

The third attempt by the Internal Revenue Service to limit capital gain treatment for gains from the sale of depreciable property took the form of a contention, under Section 117(j) of the 1939 Code, or Section 1231 of the 1954 Code, that the assets in question were held "primarily for sale to customers in the ordinary course of [taxpayer's] trade or business" and that profits on such assets' sale thus were ineligible for capital gain treatment.

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[18] Hearings before the Committee on Ways and Means, House of Representatives, 81st Cong., 2nd Sess., "Revenue Revisions of 1950," Volume 1, page 71.

That attempt also failed. That approach was closed off in the *Philber* case, 237 F. 2d 129 (3rd Cir. 1956), discussed *supra*, pages 27-28, and abandoned by the Commissioner in Rev. Rul. 54-229, 1954-1 CB 124, and in this case below.

The Commissioner's current contention represents a fourth approach, a back door through which the Internal Revenue Service hopes to be able to strike down or substantially impair capital gain treatment of such profits. The latest attempt is to claim that the useful life of business automobiles is not the usual and accepted period of four years, but is a year and a half or two years. If salvage value is then defined as meaning whatever amount the taxpayer can get for an automobile at the end of that shortened period, there is relatively little asset value left to depreciate, and there can be little or no capital gain.

The Commissioner's true objective here is to defeat the application of Section 117(j) and, in defiance of Congressional purposes, to prevent the realization of capital gains thereunder. If that result cannot be effected in any other way, apparently the Commissioner has decided that it must be done by way of upsetting the accepted definition of useful life, imposing an arbitrary salvage value limitation upon the taking of depreciation—*anything* to defeat the express statutory mandate that gains on the sale of business property shall be taxed at capital gain rates.

For although this case is in form a technical dispute about depreciation, it is, in substance, another of the Treasury Department's continuing—and thus far unsuccessful—attempts to limit, without Congressional sanction,

the application of Section 117(j) of the 1939 Code (now Section 1231 of the 1954 Code), which permits capital gain treatment of profit on the sale of depreciable property held for more than six months. The Government has said as much. At page 40 of the Government's opening Third Circuit brief in *Hertz*, No. 283, this Term, appears this frank statement:

> "The simple fact is that the profit is taxable at capital gains rates and taxpayer, under its view, receives the benefit of a deduction at a 52% rate and pays tax on the profit resulting from the increased deduction at a 25% rate. *This result can be avoided* by defining useful life for purposes of depreciation as meaning the period during which an asset is useful to the taxpayer (together with a reasonable computation of salvage value). *This has been done* in Section 1.167(a)-1(b) of the Regulations." (Emphasis added.)

This down to earth language brings the real issue into the open; it is a candid admission that the Treasury is attempting to repeal—or at least severely limit the application of—Section 1231 of the 1954 Code by the issuance of specially tailored regulations under Section 167, and to do the same to analogous Section 117(j) of the 1939 Code by taking the same position in open years under the latter Code.

The same admission has recently been made at a very high level in the Treasury. In the February, 1959 number of the *Journal of Taxation*, Mr. Darrell S. Parker, Chief of the Engineering and Valuation Branch of the Internal Revenue Service, writes:[19]

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[19] 10 *Journal of Taxation* 69, 70.

"It is evident that Section 1231 is the principal cause of the examining agent's investigation of the salvage question. It is common knowledge that consideration was given in 1958 by Congress to a proposal that the lives of various groups of depreciable assets be reduced and, if the taxpayer elected to use the group life for which it qualified, the treatment under Section 1231 would be waived upon all disposal of depreciable property included within such group." [20]

These considerations are, of course, in the highest degree, proper subjects for *legislative* action.

But the Commissioner in this case is attempting to assert a new *administrative* definition of "useful life" which,

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[20] Indeed, Congressional leadership has considered the problem as one for legislative solution. The present Chairman of the House Ways and Means Committee, Wilbur D. Mills (then Chairman of that Committee's Subcommittee on Internal Revenue Taxation), in a speech made before the American Bar Association's Section of Taxation on August 25, 1956—shortly after promulgation of the 1956 regulations—stated:

> "The fact that the new [1954] Code has substantially altered the 1939 Code in [certain] areas has, of course, left unresolved pressing substantive issues. Indeed, many of these issues have been brought into sharper focus by virtue of changes elsewhere in the Code. For example, *the accelerated depreciation methods incorporated in section 167 have changed the perspective in which the revenue consequences, the economic impact and equity considerations of section* 1231—*old section* 117(j)—*must be viewed.* A major order of business for the Subcommittee on Internal Revenue Taxation, therefore will be to cover ground not adequately or successfully explored in the 1954 revision." (Emphasis added.)

(Section of Taxation *Bulletin,* October 1956, American Bar Association, pages 9-10.)

when combined with his new definition of salvage value, would result in a disallowance to taxpayers of capital gains upon the sale of business assets under Section 117(j) of the 1939 Code.

Congress has not changed its mind.

When Congress was considering the 1954 Code, the question of capital gains on the sale of business property was specifically brought to its attention by the Committee on Federal Taxation of the American Institute of Accountants. On April 19, 1954, that group filed with the Senate Finance Committee its Recommendation No. 180 with respect to Section 1231 (Hearings before the Committee on Finance, United States Senate, 83rd Cong., 2d Sess., on H. R. 8300, Part 3, page 1324), as follows:

> "Gain or loss on property used in the trade or business, etc., should be treated uniformly as ordinary income or loss."

But Congress rejected this recommendation because it wished to encourage businessmen to sell capital assets earlier than they might otherwise sell them and, by paying the lesser capital gain tax rates on the profit that might be realized, be in a better position to buy new capital assets to take their place.

Congress made it clear in 1954, as it had made it clear before, that Section 117(j), the provision in the 1939 Code for capital gain treatment of profits on the sale of business property, was not being disturbed in the 1954 Code. Page A275 (3 U.S.C. Cong. & Adm. News [1954] 4417)

of House Report No. 1337, 83rd Cong., 2nd Sess., on H. R. 8300, states, with respect to Section 1231:

> "This section is derived from section 117(j) of the present law. There is no substantive change intended but some rearrangement has been made."

Indeed, Congress said this in the face of explicit opinion that the combination of the new depreciation methods and the capital gain provisions of Section 1231 might well "accentuate" the advantage—already existing under the 1939 Code—of the favorable capital gain tax rate over the standard income tax rate.[21]

It is highly significant that Congress limited capital gains on sales of emergency facilities in Sections 124A and 117(g)(3) of the 1939 Code (Sections 168 and 1238 of the 1954 Code); and yet left untouched Sections 23(l) and 117(j) (Sections 167 and 1231 of the 1954 Code), sections controlling this case and applicable to ordinary depreciable property.[22]

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[21] See remarks of Representative Curtis, of Missouri (a member of the House Ways and Means Committee), on H.R. 8300 at 100 Cong. Rec. 3678 (March 22, 1954).

[22] Other examples are indicated in Surrey, "Definitional Problems in Capital Gains Taxation," *Tax Revision Compendium, Committee on Ways and Means, November 16, 1959,* 1203, 1211 (footnote 26):

> "For example, World War II 5-year amortization under Internal Revenue Code of 1939, sec. 124, added by 56 Stat. 849 (1942), left the asset a capital asset; under Korean war 5-year amortization, the asset became an ordinary asset to the extent of the excess of amortization over ordinary depreciation, sec. 1238; 5-year amortization of grain storage facilities under sec. 169 permits capital gain on the sale of the facility; rapid depreciation under sec. 167(b) leaves the asset a capital asset. Sec. 1239

The Commissioner is still nevertheless trying to do, by litigation and in the 1956 regulations, what Congress re-
7 fused to do when that very question was specifically put before it.

Indeed, the President's budget message to Congress of January 18, 1960 revealed yet another proposal for legislation limiting capital gain treatment on the sale of depreciable business property:

> "Under existing law, administration of the depreciation provisions is being hampered by the attempts of some taxpayers to claim excessive depreciation before disposing of their property. If gain from the sale of depreciable personal property were treated as ordinary income, the advantage gained in claiming excessive depreciation deductions would be materially reduced and the taxpayer's judgment as to the useful life of his property could more readily be accepted. Accordingly, I recommend that consideration be given to a change in the law which would treat such gain as ordinary income to the extent of the depreciation deduction previously taken on the property." (The Budget of the United States Government for the Fiscal Year ending June 30, 1961, page M11; Congressional Record, January 18, 1960, page 583.)

(Footnote 22 continued)

prescribes ordinary income treatment for sales of depreciable property between shareholder and corporation in certain family settings; sec. 707(b)(2) is a similar provision relating to sales between a partnership and a partner.

"In addition, the Commissioner has attempted to meet this general problem by limiting the amount of the depreciation deduction through a definition of useful life that takes account of the probable sale of the assets and through a measure of salvage value that takes account of the value at sale. See *Hertz Corporation* v. *United States* —, F. 2d — (3d Cir. 1959)."

Even more revealing is the letter of February 12, 1960 from the Secretary of the Treasury to the Vice President and the Speaker of the House of Representatives (reproduced in full at Appendix B, *infra*, pages 92-93), transmitting proposed legislation to implement the President's recommendation. The letter says, in part:

> "The proposed statutory change which would require that gains from sale of depreciable personal property be treated as ordinary income, to the extent of depreciation previously claimed, would make it possible for agents of the Internal Revenue Service to accept more readily taxpayer judgments and taxpayer practices with respect to depreciation rates and salvage value. In short, if enacted the proposed legislation, by eliminating the opportunity which now exists of converting ordinary income into capital gains, would contribute to the sound administration of the depreciation laws."

Why should the proposal make it possible for Internal Revenue agents to accept "more readily" taxpayer judgments and taxpayer practices on depreciation—unless, as is clearly the case, the Commissioner is administering the depreciation deduction not on the basis of the statutory standard of "exhaustion, wear and tear," but on the basis of how much capital gain a given depreciation rate will produce. With or without the legislation which the Treasury now asks, the depreciation statute remains the same, and in the absence of Congressional action is not to be administered in different ways depending on whether another statute remains in force or is discarded.

Congress may, if it wishes, eliminate capital gain treatment following depreciation of business property, which the Treasury admits "now exists"; the Commissioner may not do so by accepting "more readily" or less readily depreciation principles established for decades under the statute, cases, regulations and the Commissioner's own pronouncements.

The proper forum for the arguments advanced by the Commissioner in the case at bar is Congress, not the courts. The many thorough studies by legislative committees[23] and others[24] on possible changes in the depreciation and capital gain provisions of the present Internal Revenue Code point the way for Treasury action through the accepted procedure—the legislative process.

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[23] See, for example, *The Federal Revenue System: Facts and Problems 1959, Materials Assembled by the Committee Staff for the Joint Economic Committee, Congress of the United States,* Joint Committee Print, 86th Congress, 1st Session, pages 45-66, 67-82; *Tax Revision Compendium, Committee on Ways and Means, November 16, 1959,* pages 793-931, 1193-1299.

[24] These include the examination of proposals for *statutory* action in the precise area here involved:

> "Short lived property may well need specific statutory treatment to distinguish 'service life,' 'economic life,' salvage or sales proceeds, etc. *Cf. The Hertz Corp.* v. *United States,* 165 F. Supp. 261 (D. Del. 1958), appeal pending; *Evans* v. *Commissioner,* 59-1 USTC ¶ 9208, 3 AFTR 2d ¶ 59-415 (9th Cir. 1959)."

(American Bar Association, Section of Taxation, 1959, Program and Committee Reports to be Presented at the Twentieth Annual Meeting of the Section to be held August 20-25, 1959, Miami, Florida, Report of the Committee on Depreciation and Amortization, page 38, footnote 14.)

A Treasury regulation is proper if it implements the law or if it explains or clarifies its meaning or if it facilitates its administration. But a regulatory provision is improper and invalid if, in the guise of any such purpose, it contradicts the clear intention of Congress. When the Treasury issues a regulation to the effect that depreciation is not allowable with respect to good will (Regulations 111, Sec. 29.23(l)-3), the regulation is valid and enforceable despite the fact that the statute does not itself except good will from the coverage of the statute. Congress was not trying to encourage the write-off of good will so that the taxpayer might go out and buy more good will. The provision on good will is thus consistent with Congressional intention.

But the new "useful life" and "salvage value" definitions asserted by the Commissioner in this case and in Reg. Sec. 1.167(a)-1(b) and (c) of the 1956 regulations (Appendix A, *infra*, pages 89-91), represent an attempt to write into the Internal Revenue Code, by administrative fiat, provisions which are in direct contravention of the clear intent and purpose of Congress, and which should therefore be declared nullities.

ADDENDUM
on
AMERICAN AUTOMOTIVE LEASING ASSOCIATION

The Commissioner mentions the American Automotive Leasing Association's Fifth Circuit *amicus curiae* brief[25] in *Hillard*, 31 T.C. 961 (1959), now *sub judice* in the Fifth Circuit (Brief for the Petitioner, pages 9-10, 30-35).

(1) We are unaware of any support, in the record or otherwise, for the Commissioner's allegation that the Leasing Association comprises or speaks for "an important segment of the automobile leasing industry" (brief, pages 9, 30).

(2) The Government's filing and service of the Association's brief in the proceeding at bar appears to be an attempt at a rather informal *amicus curiae* intervention in this Court, in violation of the Court's Rule 42.

(3) Without knowing in some detail the Leasing Association members' operating methods, tax practices and possible agreements on depreciation with the Internal Revenue Service, we feel constrained to withhold extended comment either on the merits of the arguments advanced

[25] Although the Commissioner apparently assumes that the Association's brief was "filed," the only occurrence in that connection of which we are aware is the Association's filing on October 5, 1959, of a motion for leave to file the brief. The Clerk of the Fifth Circuit has advised us that the court has taken no action on this motion.

by the Association or on the vehemence with which they are expressed.

(4) If the Association's brief is properly before this Court at all, it should be pointed out that the entire legislative history of the basic depreciation provision of the 1939 Code and prior revenue acts, and the long-standing interpretation of the terms "useful life" and "salvage value," the cases, the administrative practice, the Commissioner's own pronouncements, expert opinion, and practice in the accounting profession—all are ignored. In fact, all considerations of any kind are subordinated to one private objective of the American Automotive Leasing Association: Overcome the Commissioner's contention in *Hillard* that the vehicles in question in that case constituted property held primarily for sale to customers in the ordinary course of the taxpayer's business. (We understand that most of the members of the Association operate automobile dealerships.)

Hillard operated a rent a car business, a used car business and an automobile finance business. There was substantial intermingling of the activities of these businesses (31 T.C. at 962, 965). Under the circumstances of that case, the question arose as to whether certain automobiles were held primarily for use in the rent a car business—and their subsequent sale merely a natural sequel thereto—or were inventory in the used car business.

The brief writer seems to have concluded that the greater the significance which can be built up around the use of the cars for rental purposes, and the more incidental the sale of the automobiles can be made to appear, the greater the chance of avoiding a decision that the automobiles are not

depreciable, and that the sale does not qualify for capital gain treatment under Section 117(j). Apparently, the brief writer decided that the safest way to prevent such a decision was to show the importance of the rent a car phase of the business and the insignificance of the car selling phase of the business by contending that the rent a car business was carried on for the entire useful life of the automobiles, and only then was it sold; and to deny, therefore, that the cars were leased "for a comparatively minor portion of their useful life", as the Tax Court had concluded. And the way to do that, it was apparently decided, was to adopt the Commissioner's definition of useful life as being the holding period. Then, says the brief writer, selling the cars is but an insignificant incident to car leasing, an activity which follows not just a minor portion of the cars' useful life, but their entire useful life—*by the Commissioner's definition.*

(5) Such a position forsakes the true issues in a desperate attempt to obtain an *ad hoc* result in a doubtful case, where, we note, Judge Raum found the taxpayer "evasive" and at least one of his answers "either deliberately evasive or false" (31 T.C. at 970).

(6) The Leasing Association's brief (page 43) refers to "a device or gimmick to convert ordinary income into capital gains . . . " whereas, in the light of the cases and the history of the relevant legislation, the true question is whether the Commissioner, in his zeal for maximizing the revenue, is not using "a device or gimmick" to convert proper capital gains into ordinary income.

(7) We have searched the Leasing Association's brief in vain to find any reference to the most interesting feature of the *Hillard* case: (a) The taxpayer turned over his fleet of cars every year; (b) he depreciated the cars on the basis of a three-year life; (c) the Commissioner contended that the useful life of the cars was four years.

CONCLUSION.

For the foregoing reasons, the decision of the Ninth Circuit below should be affirmed.

Respectfully submitted,

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APPENDIX A.

Treasury Regulations on Income Taxes (1954 Code):

§ 1.167(a)-1. *Depreciation in general.—*

* * * * * *

(b) *Useful life.*—For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only

when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167 (d)-1.

(c) *Salvage.*—Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, § 1.167(b)-2(a) for the treatment of salvage under the declining balance method.

The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167(b)-1, 1.167(b)-2 and 1.167(b)-3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

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APPENDIX B.

TREASURY DEPARTMENT

WASHINGTON, D.C.

IMMEDIATE RELEASE
Monday, February 15, 1960

A-761

Treasury Secretary Anderson has sent the following identical letters to the Vice President and the Speaker of the House of Representatives:

February 12, 1960

My dear Mr. President:

In his Budget Message, submitted to Congress on January 18, 1960, the President recommended that consideration be given to an amendment to the Internal Revenue Code which would treat the gain from the sale of depreciable personal property as ordinary income to the extent of the depreciation deduction previously taken on the property. The enclosed draft of proposed legislation would implement the President's recommendation.

Under existing law, gain realized by a taxpayer upon the sale of depreciable personal property used in business is taxable as long-term capital gain even though part or all of the gain may be attributable to depreciation allowances which have been taken as ordinary deductions. This has hampered the sound administration of the depreciation laws because through the medium of the depreciation deduction ordinary income may be converted into capital gain. Accordingly, agents of the Internal Revenue Service have been zealous in insisting upon full proof that depreciation rates and salvage values claimed by a taxpayer can be substantiated by expert opinion or actual experience.

Informed opinion often differs as to the period of time over which an item of machinery or other depreciable property may reasonably be expected to be useful to the taxpayer in his trade or business. The necessity of establishing a salvage value for an item of personal property also causes innumerable problems for industry and the Internal Revenue Service.

The proposed statutory change which would require that gains from sale of depreciable personal property be treated as ordinary income, to the extent of depreciation previously claimed, would make it possible for agents of the Internal Revenue Service to accept more readily taxpayer judgments and taxpayer practices with respect to depreciation rates and salvage value. In short, if enacted the proposed legislation, by eliminating the opportunity which now exists of converting ordinary income into capital gains, would contribute to the sound administration of the depreciation laws.

It will be appreciated if you would lay the proposed legislation before the Senate. A similar proposal has been submitted to the Speaker of the House of Representatives.

Sincerely yours,

Robert B. Anderson

Secretary of the Treasury

Honorable Richard M. Nixon
President of the Senate
Washington 25, D. C.

Enclosure